Emerging Chapter 11 Issues in Bankruptcy Administration

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After declining for almost a decade, chapter 11 filings increased seven percent, from 9,835 to 10,519, during the 12-month period ending September 2001. Anecdotal evidence suggests that the magnitude of cases has increased as well. Last year, a wave of major filings such as those by FINOVA Group, PG&E, Bethlehem Steel, and PSINet was capped off by Enron Corp.'s filing of the largest corporate reorganization in American history.

The increasing chapter 11 caseload does not so much present new issues for United States Trustees, as raise some difficult issues with greater frequency and in jurisdictions that have not encountered them before. Issues seen only rarely if at all by a United States Trustee, or issues that seemed peculiar to cases filed in Delaware or the Southern District of New York, now have a nationwide scope. As a result, United States Trustees will be examining those issues more closely, and in coordination with each other may develop new policies, practices, and procedures over the coming months.

The following is a discussion of just some of those issues. It is by no means exhaustive. In addition, each of these issues has emerged in the midst of significant changes to chapter 11 practice over the past 10 years. In the past, the professionals employed in a chapter 11 bankruptcy case were primarily attorneys and accountants. Other professionals may have been retained for particular purposes--auctions, sale or valuation of assets of the company, or financing. However, the overall planning and structuring of the reorganization was left largely to accountants and attorneys.

Over the past decade or so, an increasing array of new advisory services have become involved in chapter 11 reorganizations as cases have become more complex and as more sophisticated strategies are employed. Investment bankers, crisis or turnaround specialists, and financial consultants have become involved in all aspects of the troubled company's operation, both before and after bankruptcy. Their terms of employment and compensation, the standards governing their impartiality and conflicts of interest, their relationship to affiliated or subsidiary companies, and their involvement in trading of claims or other bankruptcy-related services all challenge traditional practices under the Bankruptcy Code.

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[1]The views expressed in this article are those of the author and do not necessarily represent, and should not be attributed to, the Executive Office for United States Trustees, the United States Trustee Program, or the Department of Justice.

The provisions of the Bankruptcy Code[2] that govern professionals retained in a bankruptcy case were drafted against a backdrop of the practices and ethical rules that govern attorneys.[3] The requirements of hourly billing, conflict of interest rules, restrictions on the types of business that can affiliate with a professional, and other ethical restrictions are familiar to law firms and accounting firms. Workout specialists, financial advisors, and other bankruptcy consultants may operate under different rules.

Here are some of the resulting "big case" chapter 11 issues that United States Trustees are now regularly confronting.

Crisis Managers and Disinterestedness

Often, a financially troubled business will seek the advice of these experts when financial problems first emerge before the commencement of a bankruptcy case, will want to retain their services after filing a chapter 11, and may want the expert to become part of the firm's management. However, the Bankruptcy Code imposes limits on the extent to which "professionals" can be retained under Sections 101(14) & (31) and 327 when they have served the debtor, have connections with parties related to the debtor or creditors prior to the commencement of the case, or are part of management.

This problem became the focus of litigation brought by the United States Trustee in *In re Harnischfeger Industries, Inc.* No. 99-2171 (PJW) (Bankr. D. Del.) and *In re Safety-Kleen Corp.,* No. 00-2303 (PJW) (Bankr. D.Del). In these cases the United States Trustee brought a disgorgement action against a crisis manager. Settlement discussions led to consideration of the Code's restrictions on professionals and the role that crisis managers and turnaround specialists play in management of a troubled company.

As a result of these negotiations, a set of protocols were developed that would permit debtors in possession to employ the expertise of crisis managers as part of their management, but still provide safeguards of notice and opportunity to allow creditors and other parties in interest to object to the employment of the firm.

Under the protocols, the crisis management firm can allow one of its members to serve as an officer or director of the debtor in possession, or the crisis management firm can be retained as a professional. It cannot serve in both capacities. If the crisis manager supplies an individual who serves as an officer or director, that person and the crisis management firm will be subject to 11 U.S.C. § 363 (use, sale or lease of property), and will be required to provide disclosures of any relationship with the

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[2] 11 U.S.C. §§327-330.

[3] Robert J. Landry, III and James R. Higdon, *A Primer on 11 U.S.C. § 328(a) and Its Use in Alternative Billing Methods in Bankruptcy*, 50 Mercer L. Rev. 537, 542-43 (1999).

debtor, creditor, lenders, and others. If the crisis manager is to provide non-management advisory services, the firm will apply for retention as professionals under 11 U.S.C. § 327.

Currently the protocols apply to cases filed in United States Trustee Region 3 (the Third Circuit, comprising Pennsylvania, Delaware, and New Jersey). However, they have been shared with all United States Trustees, to use as guidance in cases in other parts of the country and with different crisis managers or turnaround specialists. The experience gained may result in the development of a national set of U.S. Trustee policies and procedures to govern the employment and retention of turnaround specialists.

Indemnification

The growing role and profile of non-lawyer professionals and advisory services in chapter 11 bankruptcy cases have required them to consider new risks and liability associated with this work. *In re Merry-Go-Round*[4] served as a wake-up call for bankruptcy specialists. In this case, a major accounting and consulting firm was sued by the bankruptcy trustee, after the case converted from a chapter 11 reorganization to a chapter 7 liquidation. The trustee claimed that the reorganization failed because of a number of mistakes by the consulting firm. On the eve of trial the consulting firm agreed to settle the litigation for $185 million.

Fearing exposure to similar claims, specialists employed in bankruptcy cases have sought indemnification by the company filing the bankruptcy case. In essence, these specialists are saying, "We will advise a company in bankruptcy, but if that company decides to sue us, a bankruptcy trustee decides to sue us, or a creditor in the case sues us because of the work we do, the company has to pay the costs of defense and any judgment or settlement that results from the litigation."

The United States Trustee has opposed efforts by professionals retained in bankruptcy cases to obtain indemnification for claims arising from their work in the case. It is the position of the United States Trustee that these professionals have a fiduciary obligation to the bankruptcy estate and their service requires a high degree of skill and care, based upon special learning and advanced knowledge. All professionals should therefore be held to high standards of care analogous to those applicable to lawyers and underwriters.

In addition, indemnification undermines the debtor in possession's fiduciary duty to the bankruptcy estate. A claim by a debtor in possession against its professionals would be an asset. In the event the company prevailed in asserting any claim against a professional, indemnification would vitiate any recovery: any money recovered from the professional would have to be paid back to the

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[4]*See In re Merry- Go-Round Enterprises, Inc.,* 244 B.R. 327 (Bankr. D. Md. 2000); Anna Snider, *Ernst Pact Spells Caution in Bankruptcy,* N.Y.L.J., May 6, 1999, at 1.

professional as part of the indemnification. An attempt by a debtor in possession to indemnify a person for negligence in advance, without any possible way of ascertaining what harm might be done, is inconsistent with the duties of the debtor in possession to the creditors.

The issues and problems posed by indemnification have led the United States Trustee Program to urge the Third Circuit Court of Appeals in *In re United Artists*[5] to adopt a *per se* prohibition against indemnification of professionals appointed under Section 327 of the Bankruptcy Code. Oral argument in this case was held on December 4, 2001, and the case is now under consideration.

Section 328 Retentions

This issue sometimes arises in context of indemnification, but may arise in other contexts as well. Professionals propose to be retained under Section 328, as opposed to Section 327, to limit the court review of any compensation they receive under Section 330.

This position threatens to read the safeguards of Section 327 and 330 out of the Code. Advocates of this position argue that, for a professional retained under Section 328, review of compensation is limited to a determination of whether the "terms and conditions" of the compensation were "improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions." This standard is a more narrow standard than the "reasonableness" standard under Section 330.[6]

However, Section 328 does not create a standard separate from the standard under Sections 327 and 330 for review of compensation, but is an integral part of the structure for retention and compensation of the Bankruptcy Code. Section 327 provides the authority and limits for retention of professionals in a bankruptcy case; Section 328 provides that any reasonable terms are permissible once agreed to and approved by the court; and Section 330 provides that, whatever the terms, the compensation paid to the professionals must meet a test of reasonableness.

The typical lawyer's fee arrangement provides a simple illustration of the operation of these three provisions. Section 327 authorizes the retention of the lawyer as long as the lawyer does not hold an "interest adverse to the estate" and is disinterested. Section 328 governs the terms and conditions of the lawyer's employment, including the hourly rate that the attorney will be paid. Once the court approves the hourly rate and other terms as "reasonable," it cannot go back and change those terms unless they "prove to have been improvident in light of developments not capable of being anticipated

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[5] *Walton v. Houlihan Lokey Howard & Zukin Capital (In re United Artists)*, Case No. 00-1351 (3d Cir. 2001).

[6] See *In re B.U.M. Intern.,* 229 F.3d 824 (9th Cir. 2000); *In re National Gypsum,* 123 F.3d 861 (5th Cir.1997).

at the time of the fixing of such terms and conditions."[7] However, the total compensation that the lawyer seeks must ultimately meet the test of reasonableness under Section 330. Section 328 limits the court's ability to adjust the hourly rate. Nevertheless, under Section 330 the total compensation awarded can be less than what is requested.

Of course, the arithmetic may come out the same regardless of whether the court adjusts the hourly rate or orders the reduction of the overall compensation request. The distinction between the terms of compensation and the total compensation ultimately awarded becomes more clear when a structured fee arrangement is approved. For example, a contingency fee for a personal injury lawyer or a success fee for an investment banker must satisfy the test of reasonableness under Section 328, and the ultimate compensation awarded must satisfy the test of reasonableness under Section 330.

Critics of this interpretation would argue that it introduces the very uncertainty that structured fee arrangements are intended to eliminate. However, the reliance on Section 328 to avoid this uncertainty itself creates certain anomalies. It is hard to see why certain fee arrangements are subject only to review under an "improvidence" standard in Section 328, while a request for compensation based on hourly billing rates is subject to a test of reasonableness under Section 330

As the bankruptcy system faces different structures for compensation from other types of professionals, measurements that reflect the experience of the usual hourly fee arrangements of lawyers and accountants may need to be adjusted. The challenge is to develop a more sophisticated measure of what "reasonable" compensation entails.

Creditors' Committees and Claims Trading

A simplistic picture of the Bankruptcy Code's process for reorganization might depict a locked room with a rectangular table in the center, with the debtor's representatives seated along one side and the creditors' representatives seated along the other. The parties cannot leave the room until they agree how to divide up a pot of money that sits in the middle of the table, and that represents all the debtor is able to commit to the reorganization.

This picture assumes a fixed cast of characters among the creditor body. Creditors who have claims at the time of the commencement of the case are stuck–hence the locked room– and have little alternative but to work with the debtor for reorganization or push for liquidation of the debtor's assets.

This picture's static view of a reorganization's cast of characters fails to take into account the fact that the creditor body can change during the course of a case, because creditors can and do sell their claims. Claims purchasers are not a new phenomenon, but they are assuming a larger and more

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[7] 11 U.S.C. § 328(a).

important role in the reorganization process.[8] Their increasing role raises a number of new issues.

An acquaintance of mine recently described a situation in which he was creditors' committee counsel. In the course of the case, all of the committee members sold their claims, leaving in essence a shell of a committee. In the past, the United States Trustee could handle the occasional sale of claims by a creditors' committee member on a case by case basis. As claims trading becomes more active, it will become increasingly important to monitor the change in ownership of claims, and to develop procedures to ensure trading does not interfere with the duty that committee members owe to the entire creditor body.

An End Note

This list of issues is not exhaustive. It probably represents only a small portion of the new issues emerging during the current cycle of chapter 11 filings. Furthermore, these are not all new issues. Turnaround specialists, investment bankers, and other advisors have been appointed in bankruptcy cases in the past; there are several reported cases dealing with indemnification from the early 1990s;[9] and a market for claims against insolvent debtors has existed for years, if not decades. These issues have become more critical in bankruptcy administration because they are arising in more cases and in more jurisdictions.

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[8]Emily Thornton, *The Return of the Wall Street Vultures*, Business Week, Sept. 10, 2001, at 108.

[9]*In re Gillett Holdings, Inc.*, 137 B.R. 452, 458 (Bankr. D. Colo. 1991) (entirely improper and unacceptable); *In re Drexel Burnham Lambert Group*, *Inc.*, 133 B.R. 13, 27 (Bankr. S.D.N.Y. 1991); *In re Mortgage & Realty Trust*, 123 B.R. 626, 631 (Bankr. C.D. Cal. 1991); *In re Allegheny Int'l, Inc.*, 100 B.R. 244, 247 (Bankr. W.D. Pa. 1989).