

The role and retention of the chief restructuring officer

Shai Y Waisman, partner
John W Lucas, associate
Weil, Gotshal & Manges
LLP

During the 1990s the chief restructuring officer (CRO) was a somewhat new player in the Chapter 11 arena. However, today it would be uncommon for a debtor in possession not to employ a CRO in a large Chapter 11 reorganisation to provide crisis management experience, as well as a fresh perspective on the reorganisation process. Creditors typically support the engagement of a CRO and in many cases encourage or even demand such engagement to ensure access to information, credibility of reporting and an outside view of management that focuses on creditor expectations rather than the day-to-day operations of the company. A CRO can provide necessary assistance to the existing management team of a debtor if it is struggling with either the role of being a debtor in possession or the additional demands on time management, including bringing experience and additional resources to an otherwise frenetic and difficult process. In some instances, the debtor in possession will opt for a CRO to stave off efforts to appoint a trustee so that the company can maintain control of its reorganisation.

The use of the CRO in Chapter 11 has also raised a number of interesting and complex issues. For instance, in light of the fact that the Bankruptcy Code contains no references or provisions dealing with the retention of a CRO, on what basis is the retention of a CRO evaluated or justified? It is clear that the Bankruptcy Code did not contemplate a professional senior officer such as a CRO stepping into a management role and taking the reins of the reorganisation. The Bankruptcy Code assumes the role of attorneys and accountants in planning and guiding the reorganisation process, as the standards regarding retention demonstrate. This lack of definitive guidance in regard to CROs has often led courts to somewhat strained and uncertain decisions.

Role of the CRO

A CRO may be hired as a senior officer of the debtor in possession to supplement senior management where there is a perceived need for crisis management and added credibility to the restructuring process or, in cases of fraud, to function as an interim chief executive officer where management has been terminated or has resigned. A CRO may also need to perform a number of different roles during the restructuring process. Thus, a debtor in possession will likely try to find a CRO that has hands-on expertise and experience in the debtor's industry and in restructuring, as well as an ability to interact with and bring together the different sectors of a company's business and its various constituencies.

While each restructuring and Chapter 11 case presents different and unique challenges, set out below are some basic objectives observed by commentators that CROs should strive to accomplish early on in the restructuring process:

- Alter the culture – a CRO must first work to establish control of the distressed company while also imparting the need for dynamic change and improvement with respect to the management of the company. This objective should extend solely to those areas of the organisation that could impede a successful restructuring. There is no need to change a corporate management that is healthy and has not contributed to the company's business failings.
- Adapt to the culture – it is important for a CRO to establish trust and credibility with management and the general workforce. The debtor's employees will understandably be nervous and confused, and part of creating a sense of control over the reorganisation is to have the trust and confidence of the employees.
- Identify the problem – more important than merely identifying the problem with the business is to convince management that the problems exist and may be a result of their policies or programmes. If this is not accomplished early on, the restructuring cannot begin in earnest; if delayed too long it could jeopardise the chances of rehabilitating the troubled company. A CRO must also identify the interests and motivations of each creditor constituency and aim towards building a consensus that will ultimately achieve a successful restructuring, even if such decisions are not popular with current management.
- Identify the core business – in order for the business to reorganise successfully, there must be a core, profitable business around which the reorganisation can be structured.
- Identify the end game – finally, it is imperative that a CRO identify the goal of the reorganisation and move the debtor and its management and workforce towards this goal.

In the end, the goal of a CRO is to restructure a distressed company's balance sheet and make the difficult determination of defining the company's business within a compressed timeframe. An effective CRO insulates the company's officers from the detailed reorganisation process by leaving them free to pursue the day-to-day operations of the company and implementation of the new business model.

CROs versus Chapter 11 trustees

There is a natural and understandable tendency to compare the role of a CRO with that of a Chapter 11

trustee. Both parties are retained in order to provide a fresh and objective approach to the operation of the debtor's business and prospects for reorganisation. In addition, each may be retained at the request of creditors to ensure fair and objective decision making by the debtor and an elimination of 'business as usual'. A company that does not want to relinquish control of the reorganisation process and the company, or creditors which either cannot or do not wish to make the legal case for appointment of a trustee or its various consequences, may opt instead for the appointment of a CRO.

Indeed, both debtors and creditors prefer a CRO to the more drastic remedy of a Chapter 11 trustee. Stakeholders will frequently take the view that retention of a CRO, in lieu of appointing a trustee, can ameliorate these concerns. For instance, a CRO with industry and/or turnaround experience could assure the business community that the debtor is serious about its restructuring and not looking merely to administer the estate towards a liquidation. Moreover, CROs are frequently suggested to the debtor by the stakeholders and while this sometimes leads to initial distrust or lack of confidence in the CRO by management, it can also be the cornerstone of credibility with those stakeholders. Finally, retention of a CRO may not be as costly as a trustee. A CRO may have previous industry experience and thus may not require as much time to become familiar with the debtor's business or its day-to-day affairs. Accordingly the CRO, as opposed to a Chapter 11 trustee, is unlikely to need new or additional professionals (eg, lawyers, financial advisers) and is more likely to work with current management rather than replacing it. It is for these reasons that debtors and creditors tend to prefer the retention of a CRO over the appointment of a trustee.

Potential drawbacks of the appointment of a trustee

Unless current management is accused of fraud or gross mismanagement, creditors and shareholders may be reluctant to support the appointment of a trustee because of the perception that trustees lack industry or business experience. More importantly, once a Chapter 11 trustee is appointed, a debtor in possession's exclusive right to propose a Chapter 11 reorganisation plan is terminated. Thus, the debtor in possession is no longer in control of the reorganisation process; once the exclusivity is terminated, any party in interest may submit a

competing plan, which may delay the reorganisation process.

Secured stakeholders are not permitted to elect a Chapter 11 trustee because Section 702(a) provides that only non-insider, disinterested creditors holding unsecured claims may vote for a candidate for trustee. The effect of this provision is that the creditor group that often has the largest stake in the outcome of the Chapter 11 case, the secured creditors, is excluded from the decision of who is most appropriate to guide the case through confirmation. Moreover, Section 702 does not distinguish between senior and subordinated claims. Thus, while secured creditors are excluded from the election of a trustee, contractually subordinated creditors may not only participate but, depending on the size of their claims, may actually control the election. Accordingly, creditors may prefer to maintain the debtor in possession (or request a CRO) in lieu of having a trustee appointed.

One major concern with a trustee is the business community's perception, whether justified or not, that a trustee is more inclined to liquidate the debtor than to reorganise. If a potential customer or client believes the appointment of a trustee may negatively affect the debtor's business prospects, it may be less likely to do long-term business with the debtor. Regardless of whether the trustee intends to liquidate, such uncertainty may have an adverse impact on the debtor's bottom line and prospects for a successful reorganisation. Even providers of debtor-in-possession financing are sceptical of providing funding to an operating trustee and typically can call a default if one is appointed.

Inherently, there are certain costs that must be incurred by a trustee in order to become familiar with the debtor's business, culture and industry. These transitional costs are compounded by the fact that a trustee will hire new professionals (eg, attorneys, financial advisers) who must meet the standards of disinterestedness and who are more familiar to the trustee.

Examiners and CROs

The appointment of an examiner is provided for in Section 1104(c) of the Bankruptcy Code. An examiner is a less extreme measure because it permits the debtor in possession to maintain control of the company and the restructuring process, but also provides an independent party to investigate certain management actions. The examiner first undertakes an investigation and then

provides recommendations to the debtor's management. In *In re Enron Corp*, a case precipitated by fraud, the appointment of both a CRO and an examiner satisfied creditor constituencies and the court that the necessary investigations of the debtor's former management could proceed without the more draconian remedy of a trustee. Similarly, in *In re WorldCom, Inc* the appointment of a CRO and an examiner, and the pending appointment of a new chief executive officer satisfied the parties.

Standards for retention of a CRO

There is no provision in the Bankruptcy Code that specifically governs the hiring of CROs. However, in the absence of a clear directive, debtors have relied on several provisions of the Bankruptcy Code for the retention of a CRO.

Section 327(a)

Section 327(a) of the Bankruptcy Code provides a debtor or trustee with the authority, subject to court approval, to "employ one or more attorneys, 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". Since a CRO does not fit nicely into one of the specified categories (ie, attorneys, appraisers or auctioneers), courts and commentators have focused on the issue of whether a CRO may qualify under the catch-all 'other professional persons'.

It is uncertain whether a CRO (who typically functions as an officer) is a 'professional person' under Section 327(a), as such term is not defined in the Bankruptcy Code and case law on this issue is lacking.

As the title suggests, courts have found CROs to be 'officers'. An officer of a debtor will typically be considered an ordinary course employee and not a professional. However, in *In re Madison Management Group, Inc* the court found that there are certain instances where the special expertise of the officer elevates that person to the status of a professional. Form is not determinative – the courts should evaluate the function and role of the person to be retained when deciding whether such person is a professional. In *Madison Management* the court set out 12 factors that should be considered when deciding whether an officer of the debtor is a professional:

- What duties does the CRO perform (executive or consulting by nature)?
- Are former management still employed?
- Does the CRO make executive decisions?
- Is the CRO primarily employed as a consultant or trained executive?
- Is compensation paid directly to the CRO or to another entity?
- Does the CRO receive fringe benefits?
- Are income and withholding taxes withheld from the CRO?
- Is the CRO's compensation consistent with compensation paid to predecessors?
- Is the employment permanent or was the CRO brought in to solve the debtor's financial problems?
- Was the CRO employed contemporaneously with the petition date?
- Does the CRO work full time?
- Is the CRO paid a retainer?

In the end, the issue is not whether the person to be retained is technically a 'professional person', but whether the person being retained will play a central role in the administration of the reorganisation case and thus must be approved by the court. At first glance senior management, including a CRO, appears to meet this standard. However, the provision in the former Bankruptcy Act that required the judge to set compensation levels for senior management was excluded from the Bankruptcy Code. Regardless, several courts have held that the employment and compensation of officers of the debtor are subject to the scrutiny of the court pursuant to Section 327.

If retention is sought pursuant to Section 327(a) and the CRO is found to be a professional, the CRO must demonstrate that he is disinterested and does not hold or represent an interest adverse to the estate. Section 101(14) of the Bankruptcy Code defines a 'disinterested person' (in pertinent part) as someone that:

- "is not a creditor, an equity security holder or an insider" of the debtor;
- "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
- "does not have an interest materially adverse to the interest of the estate... by reason of any direct or indirect connection with, or interest in, the debtor".

The disclosure requirements are very strict and extend to all connections to the debtor and the

debtor's creditors and professionals. It is in this context that most objections arise to the retention of a CRO. Establishing disinterestedness can be challenging where the CRO is employed as an officer pre-petition. Section 101(14)(B) would indicate that service as an officer pre-petition would *per se* render a CRO not disinterested. However, Section 1107(b) of the Bankruptcy Code provides that a person to be retained under Section 327 is not disinterested solely because he was retained by the debtor in the pre-petition period. In *Madison Management*, the court stated the retention of the CRO was permitted despite his appointment prior to the commencement of the bankruptcy case because Section 1107(b) permits a debtor to retain a officers and other employees even if they are not disinterested.

If a CRO or other professional is retained pursuant to Section 327 and is later found not to be disinterested, the penalty can be severe, including forfeiture or denial of fees incurred for work performed during the case.

Section 327(b)

In at least one reported case, a bankruptcy court found that a debtor's retention of CROs without court approval is permitted when such persons are hired to replace existing officers for the purpose of running and restructuring the company for the best interests of the company and all parties in interest. In *Phoenix Steel*, the court found that a court-authorized post-petition retention of three individuals hired pre-petition to perform turnaround management services for the debtor was not necessary because the three individuals made decisions as officers and did not take orders from others regarding the company's day-to-day affairs or the restructuring. The court, however, found that if the duties of a debtor's officer, such as a CRO, fit within any part of Section 327, such professional's compensation is always subject to the court's review and the requirements under Section 330 of the Bankruptcy Code (review of compensation of officers). In such cases, it is not practical for the court to review the compensation for all officers of a debtor, but only those that are essential to the reorganisation. And unlike the review of compensation of attorneys and financial advisers, a court will not require time records and a detailed account of the professional's activities, but will compare the salary to the officers that were replaced and others in the industry.

Section 363(b)(1)

It is becoming increasingly common for debtors to seek retention of a CRO or a crisis manager under Section 363(b)(1) of the Bankruptcy Code, which permits a debtor or trustee to use property of the estate outside of the ordinary course of business if such use is approved by the court after notice and a hearing. As noted above, several courts believe that CROs qualify as 'professional persons' as contemplated by Section 327(a) and thus must be retained in accordance with that section's strict standards. Since the Bankruptcy Code specifically contemplates and regulates the employment and retention of 'professional persons' through Sections 327 and 101(14), there is an issue as to whether it is appropriate to retain a CRO as a use of property of the estate outside of the ordinary course of business under Section 363(b).

The Harnischfeger and Safety-Kleen Protocol

In Region 3, covering the states of Pennsylvania, Delaware and New Jersey, the US trustee and a prominent restructuring advisory firm whose employees are routinely engaged as CROs in Chapter 11 cases entered into a stipulation aimed to resolve the Section 363 retention dispute. In *In re Harnischfeger Industries, Inc* and *In re Safety-Kleen Corp* the US trustee objected to the retention of the restructuring firm, alleging that it failed to satisfy the disinterestedness standard under Sections 327 and 101(14), and also objected to the terms of the debtor's proposed indemnification of the restructuring firm for services performed. The parties eventually settled and agreed upon a protocol requiring compliance with certain terms in future retentions. The most pertinent terms of retention are set forth below:

- The restructuring firm's CROs agreed to serve in only one of the following capacities:
 - crisis manager under Section 363;
 - financial adviser under Section 327,
 - claims agent/administrator under 28 USC Section 156(c); or
 - investor/acquirer.
- Once retained to serve in one of these capacities, it may not switch to a different position in the same case.
- The CROs are required to file an application under Section 363 of the Bankruptcy Code and must identify the individuals who will serve in executive positions, as well as the names and proposed functions of any additional staff to be

employed. Since it is impossible to predict staffing needs at the commencement of the case, the restructuring firm must also file a monthly report on staffing assignments and needs for the previous month. This report must be circulated to the US trustee and each of the official committees, and may be subject to review by the court in the event that an objection is filed.

- The retention of CROs (or their firms) as executive officers must be approved by an independent board of directors under applicable corporate governance law. Such officers will also act under the direction, control and guidance of the independent board, and will be subject to removal by a majority of such independent board.
- Regardless of the fact that the retention is being pursued under Section 363, the firm or individual to be retained must make all of the appropriate disclosures required by a professional retained under Section 327. The retained party must also supplement such disclosures as needed throughout the retention.
- The restructuring firm will not seek retention in any case where a principal, employee or contractor of such firm is or, within the past two years, was a director of the debtor.

The most pertinent terms of compensation are as follows:

- The retention application must disclose the compensation terms, including any hourly rates and success or similar fee.
- The restructuring firm must file and serve a quarterly notice to the US trustee and each official committee, summarising the services provided by restructuring firm, the compensation earned by each executive and staff employee and expenses incurred. This notice may be subject to court review in the event that there are any objections.
- Any success or similar fees will be subject to a 'reasonableness' standard at the conclusion of the case and such fees cannot be pre-approved under Section 328(a).
- Anyone serving as an officer of the debtor may be indemnified in the same manner and scope as the debtor's other officers and directors, including any insurance coverage under the debtor's directors' and officers' liability policy. No other indemnification will be allowed (ie, the restructuring firm will not be separately indemnified).

These protocols are not necessarily enforced in other jurisdictions; nor is a restructuring firm's eligibility to provide turnaround services to a debtor subject to entering into a stipulation such as that discussed above. However, these protocols have become a model for the approval of the retention of CROs pursuant to Section 363 of the Bankruptcy Code in the Southern District of New York and other jurisdictions.

Fiduciary duties and other ethical issues of the CRO

As a general matter, officers of a corporation owe fiduciary duties, including the duties of care and loyalty, to the corporation under state corporate law. Since the early 1990s, creditors relied on *Credit Lyonnais Bank Nederland NV v Pathe Communications Corp* for the proposition that the fiduciary duties of officers and directors run to creditors when the company is insolvent or in the zone of insolvency. In response, creditors often threatened action against officers and directors as a means of controlling the reorganisation process to their advantage.

Then, in 2004 the Delaware court clarified its position in *Production Resources Group, LLC v NCT Group, Inc*, holding that the majority view had been misinterpreted. The *Production Resources* court found that the *Credit Lyonnais* decision did not create a cause of action, but merely acknowledged that officers and directors may take into account the rights and interests of creditors. Most recently, the Delaware Supreme Court in *North American Catholic Educational Programming Foundation, Inc v Gheewalla* held that the *Credit Lyonnais* decision should not be understood to mean that the actions of all insolvent corporations must favour creditors. Rather, actions of corporate officers of insolvent corporations that are supported by the business judgement rule are generally immune from action, whether such actions favour shareholders or creditors. Notably, the effect of *Gheewalla* removes some of the uncertainty for directors and officers, who have a fiduciary duty to exercise their business judgement in the best interest of a company regardless of its solvency. As a result, the decisions of CROs are protected from creditor attacks as long as they are made in accordance with the business judgement rule, in good faith and upon a reasonable belief that the action they are pursuing

is in the best interests of the company.

The ethical issue most frequently faced by CROs is the concern that the CRO may be serving more than one 'master'. The source of this concern is that CROs are typically referred to a debtor or trustee by another party in interest and the prospect of future referrals may be viewed as affecting the CRO's loyalties and decision making to achieve the best result (or at least avoid a bad result) for the particular creditor group that made the referral. This dilemma is especially acute when the CRO is faced with decisions affecting the confirmation of a reorganisation plan over the objection of certain classes of creditors, sales of assets or the pursuit of actions to recover assets against the very creditors that recommended its retention.

According to the Code of Ethics established by the Turnaround Management Association, the answer is straightforward – a "member's duty is solely to the client" (Code of Ethics 2.2). In the case of a CRO in a Chapter 11 case, the client is the debtor and its estate, which retained the CRO and pays its fees. In addition, the bankruptcy process itself provides sufficient checks against concerns that a CRO is not acting in the best interests of the estate. Parties in interest have the right to object to proposed actions by the debtor under Section 1109 of the Bankruptcy Code or to seek to terminate exclusivity under Section 1121 of the Bankruptcy Code or appoint a trustee if there is a lack of confidence in the CRO under Section 1104 of the Bankruptcy Code.

Conclusion

The need for restructuring experience and credibility with a debtor's stakeholders supports the appointment of CROs. In no way should we mistake a CRO for a trustee, because CROs do not have the same statutory responsibilities and obligations and management need not give up control of the company and restructuring process. From the point of view of debtors and their stakeholders, a CRO provides an attractive alternative to a trustee, which is regarded as a far more drastic remedy, with attendant uncertainty. While there are a number of issues surrounding the retention and role of CROs in Chapter 11 cases, the courts and US trustees continue to make progress in defining workable standards.