The Future of the USTP's CRO "Protocol"

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Seventeen years ago, the United States Trustee Program (USTP) entered into settlement agreements regarding the terms for the retention of firms providing Chief Restructuring Officers (CROs) and other staff to assist debtors-in-possession (DIPs) with their chapter 11 duties. These settlements, which have come to be known as the "J. Alix Protocol" (protocol) after the firm involved, apply the conflict of interest provisions of the Bankruptcy Code to the hiring of CROs who are charged with mixed professional and business management duties. Courts have approved hundreds of these settlements, which allow employment under § 363(b) (use of estate property outside the ordinary course of business), while applying the relevant conflict protections of § 327(a) (employment of professionals). These settlements have brought predictability and consistency to CRO engagements. Nonetheless, after almost two decades during which the complexity of bankruptcy reorganizations and CRO industry practices have changed significantly, the USTP began outreach to stakeholders more than a year ago to discuss how to update the protocol without disturbing its essential features. While that process unfolds, the USTP will continue to follow the protocol and to object to applications that do not comply with it.

Background

In 2001 in the cases of *In re Safety-Kleen Corp*.[1] and *In re Harnischfeger Industries, Inc.,*[2] bankruptcy courts approved the USTP's settlements of its objections to the DIPs' applications to retain a CRO and the CRO's firm as a restructuring advisor. These cases provided a template for USTP agreements on the employment of CROs that allowed the CROs' employment under § 363 and applied § 327(a)'s relevant conflict protections, such as the bar on a professional's service as a director. CROs, which are hybrids with professional responsibilities covered by § 327(a) and executive functions covered by § 363, did not exist 40 years ago when the Code was adopted. Although DIPs retain authority to appoint *traditional* corporate officers and *salaried*

[1] Case No. 00-2303 (Bankr. D. Del. 2000).

[2] Case No. 99-2171 (Bankr. D. Del. 1999).

professionals without court approval,[3] the hybrid nature of the CRO's engagement makes them neither fish nor fowl or, perhaps more accurately, both fish and fowl. CROs are not wholly a traditional corporate officer no matter how traditional many of their duties may be, and a DIP's decision to hire a CRO is by definition outside the ordinary course of business.[4]

In settling, the USTP recognized the dual nature of the engagements, the litigation risk arising from a CRO's legally uncertain status under a Bankruptcy Code that never contemplated their existence, and the debtors' legitimate need for CRO services at a time of crisis. The USTP's goal was two-fold: (1) to take a principled approach in harmonizing the applicable Code provisions; [5] and (2) to provide notice of the USTP's litigating position on this complex issue.

As the Supreme Court has stated many times, statutory interpretation is a "holistic" endeavor,[6] which should avoid rendering other statutory provisions unnecessary and should avoid interpreting them inconsistently with the policy of another provision.[7] Statutory construction requires reading "the statutes to give effect to each if we can do so while preserving their sense and purpose."[8] Consistent with these canons, the protocol gives the fullest effect to all of the pertinent Code provisions, including § 363(b) and § 327(a).

The protocol has no force of law. It merely telegraphs to the bankruptcy community how the USTP interprets and will apply the law in carrying out its statutory duty to review

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[3] *See Jacobson v. AEG Capital Corp.,* 50 F.3d 1493, 1500 (9th Cir. 1995) ("directors still have the power to elect officers") (quotation omitted); 11 U.S.C. § 327(b) (professionals regularly employed on salary are subject to § 327(b), not § 327(a)).

[4] Restructuring in bankruptcy can never be considered "ordinary course" for any business, and courts have approved the retention of restructuring professionals under § 363(b). *See*, *e.g*., *In re Liberty Asset Management Corp.,* No. 16-13575 (Bankr. C.D. Cal. Jun. 9, 2016), Docket No. 94; *In re Interfaith Medical Center,* No. 12-48226 (Bankr. E.D.N.Y. Jan. 25, 2013), Docket No. 177; *In re Qualteq, Inc.,* No. 11-12572 (KJC) (Bankr. D. Del. Sept. 2, 2011), Docket No. 135; *In re Hartford Computer Hardware, Inc.,* No. 11-49744 (PSH) (Bankr. N.D. Ill. Apr. 12, 2012), Docket No. 270; *In re Colad Grp., Inc*., 324 B.R. 208, 215 (Bankr. W.D.N.Y. 2005).

[5] Section 327(a)'s rigorous disinterestedness requirement makes any officer ineligible for professional employment notwithstanding § 363's more deferential business judgment standard. Indeed, it is this statutory conflict and the hybrid nature of CRO engagements that was the genesis for the protocol in 2001.

[6] *United Sav. Ass'n v. Timbers of Inwood Forest Assocs. Ltd.*, 484 U.S. 365, 371 (1988).

[7] *Ratzlaf v. United States*, 510 U.S. 135, 140 (1994); *Timbers of Inwood*, 484 U.S. at 371.

[8] *Matter of Spanish Peaks Holdings II LLC,* 872 F.3d 892, 899 (9th Cir. 2017) (quoting *Watt v. Alaska*, 451 U.S. 259 (1981)).

applications to employ. Even though a few courts have criticized the protocol as too accommodating to the CRO industry,[9] most courts and the CRO firms have widely accepted and followed the protocol. The USTP therefore intends to continue to follow the protocol and to enforce it consistently. Likewise, if proposed CROs deviate from the protocol, the USTP will continue to object to their employment applications under § 327.

Key Provisions of the CRO Protocol

The key ethical and disclosure components of the protocol can be summarized as follows:

- The protocol incorporates § 327(a)'s and § 101(14)'s prohibition on serving, or having served within two years, on a debtor's board. This is important because the two-year ban is a bright-line rule set forth in statute. Directors, not officers, are vested with ultimate management authority and owe a duty of loyalty to the corporation. A board must be independent of the CRO to prevent actual or apparent conflicts of interest, which are key aspects of § 327(a). For example, if the CRO serves on the board while that same board decides to retain the CRO's firm, this insider transaction presents a conflict of interest.

- The protocol incorporates § 327(a)'s conflict of interest rules to bar those with an actual conflict of interest from being retained. The protocol also avoids conflicts of interest by preventing the CRO from managing the engagement to the financial benefit of the CRO's firm. It does so by establishing the so-called "one hat rule"—allowing the professional to serve in only one capacity, such as CRO, crisis manager, financial adviser, claims agent, or investor. Similarly, it also bans the CRO's firm from investing in the DIP for two years after the engagement concludes.

- The protocol incorporates the disclosure requirements governing a § 327(a) application by requiring an affidavit setting forth connections with parties and professionals. These disclosures are analogous to those required under Fed. R. Bankr. P. 2014. Disclosure and transparency are key to evaluating potential conflicts of interest and enhancing public confidence in the integrity of the system.

- The protocol requires disclosure of staffing and compensation, as well as court review of compensation under a "reasonableness" standard, which is analogous to the review of

[9] *E.g., In re Mirant Corp.,* 354 B.R. 113, 127 n.29 (Bankr. N.D. Tex. 2006) ("The UST and other parties acquiesced in this method of retention [under § 363] (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 Debtors). The court is not satisfied that use of Code § 363 is appropriate for such a purpose, but need not here reach that issue." *Id. Contra In re Ajubeo, LLC,* 2017 WL 5466655, *4 (Bankr. D. Colo. Sept. 27, 2017) (approving CRO's retention under § 363 and stating that the "Court believes it is enforcing the Code . . . ").

compensation of professionals employed under § 327(a). Approval of retention under § 363 alone would deprive the court and the parties of their critical role in protecting the estate by evaluating the justifications for the fees and other payments made to key players who are employed to guide the debtor company through the bankruptcy process.

The USTP Consistently Follows the Protocol

The USTP widely disseminated and posted the protocol, as well as gave notice that the USTP would object under § 327 to any CRO employment application that failed to comply with every component of the protocol.[10] As stated in the USTP Manual posted on our website, "if the debtor or crisis manager rejects any term of the *Jay Alix Protocol*, the United States Trustee retains the right to object to all issues regarding the crisis manager's employment, including the request to be retained under section 363 rather than section 327."[11] It is fair to say that the USTP's reserved § 327 objection for violations of the protocol is as much a part of the protocol itself as are the conflict and disclosure provisions.

The USTP has occasionally, but rarely, been forced to object to CRO retentions under § 327.[12] More commonly, the USTP resolves these objections once the CRO comes into compliance with the protocol or the debtor withdraws its application if compliance is not possible. The relative absence of CRO retention litigation over the last 17 years is a testament both to the protocol's widespread acceptance and to the CRO firms' adherence to it.

Just as the USTP seeks to bring integrity and efficiency to the bankruptcy system, it likewise seeks to bring predictability and stability through consistent litigating positions. Any major changes in the jurisprudence governing CRO retentions would create uncertainty and inefficiency for all parties, the court, and the USTP.

One recent court decision calls into question the future viability of the protocol and may reopen previously settled questions about CRO retentions going forward. In *Nine West*, the debtors sought to retain a restructuring firm to provide an interim CEO and to retain the firm itself to provide additional restructuring services.[13] The CEO had served on one debtor's board

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[10] *See* https://www.justice.gov/ust/file/volume_3_chapter_11_case_administration.pdf/download (USTP Manual).

[11] *Id.* at 106-07.

[12] *See, e.g., In re Patriot National, Inc.* (Bankr. D. Del. 2018); *Ajubeo,* 2017 WL 5466655; *In re Adams Resources Exploration Corp.* (Bankr. D. Del. 2017); *In re The Adoni Group, Inc*. (Bankr. S.D.N.Y. 2014); *In re Revstone* (Bankr. D. Del. 2013).

[13] *In re Nine West Holdings, Inc.,* 2018 WL 3238695 (Bankr. S.D.N.Y. July 2, 2018).

of directors for several years and resigned only once the bankruptcy filing was imminent. Thus, given the failure to comply with the protocol's sine qua non of an independent board, the USTP objected to the retention under § 327.[14]

The *Nine West* court seemingly approved of the protocol and its ethical protections, noting that "[r]equiring parties to comply with the Protocol has served as a way to avoid conflicts of interest."[15] But in overruling the USTP's § 327 objection, the court applied neither § 327 nor the protocol and instead ruled that "nothing precludes the Debtors from relying on section 363(b) to seek authorization for the retention of [the restructuring firm and CEO]."[16]

If case law develops that § 363 is the sole hurdle for CRO applicants, then the protocol may become obsolete and other unintended consequences may follow. For example, because § 363 independently imposes no disclosure requirements or conflict of interest standards,[17] the result could be little transparency and accountability for those arguably serving in the most critical role in the chapter 11 case. Furthermore, a "§ 363-only" rule renders future CRO applications susceptible to ad hoc standards, thereby depriving debtors and the CRO industry of the predictability and stability that the protocol affords. And if officers provided by restructuring firms are like any other corporate officers and are not subject to § 327's constraints incorporated in the protocol, then those officers are likely insiders for all purposes, including § 503(c)'s limits on insider compensation and bonuses for the firm.

Future of the Protocol

Like all policies and practices, the protocol is worthy of reevaluation from time to time. Indeed, the USTP has publicly stated that "[w]e have reached out to participants in the restructuring business and other stakeholders for information on how the Protocol should be updated to account for the facts of modern practice, while remaining faithful to the conflict of

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[14] The USTP has never knowingly failed to object to a CRO's and his or her firm's retention when a firm member has served on a debtor's board. For example, in *In re Allen Systems Group* (Bankr. D. Del. 2015), one of the principals of the CRO's firm had served on the board pre-petition in violation of the protocol. The USTP filed an objection under § 327, and the firm withdrew its application because the conflict could not be remedied.

[15] *Nine West*, at *6. The court further recognized that the protocol is "designed to avoid the 'inherent conflict' between an advisor's duty to a debtor and its own business interests where the advisory firm serves both as a financial advisor retained pursuant to § 327 of the Bankruptcy Code and as a crisis manager with firm staff serving as officers of the debtor corporation." *Id.*

[16] *Id.* at *8.

[17] At least, not beyond what would be necessary to show a proper exercise of a DIP's business judgment as opposed to the more rigorous standards of § 327 imported into the protocol.

interest provisions of the Code."[18] In our outreach to stakeholders, we have explained that in considering any changes to the protocol we will follow a process similar to that followed for the large case fee guidelines issued in 2013—acquire information, publish for comment (even though the Administrative Procedure Act does not apply), convene a public meeting, and issue an updated CRO protocol for final publication.

The USTP should be prudent and careful when considering whether to modify longstanding policy on which creditors, debtors, and professionals alike have relied. Thus, we are considering potential consequences as we deliberately reevaluate and study the protocol. For now and the foreseeable future, however, the USTP intends to continue to abide by the protocol and consistently enforce it as we have for almost two decades because we believe the protocol to be a legally-principled approach for employing CROs.

Conclusion

The USTP understands the valuable role that CROs play in business reorganizations. We developed the protocol as a workable framework for analyzing employment applications in a manner that faithfully follows the law and ensures that statutory safeguards against conflicts of interest are observed. With the growing complexity of the CRO industry, some modifications to the protocol may be appropriate. But it would be a mistake and contrary to statute to jettison the conflict and disclosure provisions of the protocol that govern all other professional retentions in chapter 11. The USTP stands ready to listen to stakeholders about updating the protocol in a way that does not violate statutory mandates. Unless and until changes are made to the protocol or law, however, the bankruptcy community can continue to rely upon the USTP to follow the protocol and to object to employment applications that deviate from its terms.

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[18] *Director's Remarks Delivered at the 33rd Annual Bankruptcy and Restructuring Conference of the Association of Insolvency and Restructuring Advisors* (June 7, 2017), available at https://www.justice.gov/ust/speeches-testimony/remarks-director-33rd-annual-bankruptcy-and-restructuring-conference-association.