EMPLOYMENT OF TURNAROUND MANAGEMENT COMPANIES, "DISINTERESTEDNESS" ISSUES UNDER THE BANKRUPTCY CODE, AND ISSUES UNDER DELAWARE GENERAL CORPORATION LAW

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CONCLUSION

INTRODUCTION

Most large debtors in possession seek the aid of turnaround managers prior to and during their chapter 11 reorganizations. Due to the structure of such engagements, debtors in possession sometimes unwittingly render the management companies ineligible for employment in a chapter 11 bankruptcy case. Whether turnaround management companies and individual management consultants are eligible for employment as "professional persons" under section 327 of the Bankruptcy Code[1] has generated significant disputes in bankruptcy courts throughout the United States. The disputes often focus on "disinterestedness" issues created by the structure under which debtors in possession engage management companies and their individual consultants. Certain of those "disinterestedness" issues may be avoided by appropriately structuring the engagement of the turnaround management company and its individual consultants. Specifically, this article addresses the "disinterestedness" eligibility of management companies to be employed under section 327(a) and suggests that management companies are eligible for employment under section 327(a) where the individual consultants, rather than the management company, are employed as officers of the debtor under section 327(b), provided that the management company is otherwise disinterested. This article also addresses certain issues that may arise under Delaware General Corporation Law ("DGCL") depending upon the structure of a debtor's engagement of turnaround management companies.

I. ENGAGEMENT OF INDIVIDUAL MANAGEMENT CONSULTANTS AND THE REPLACEMENT OF RETENTION OF PROFESSIONALS UNDER SECTION 327(B)

Section 327(b) authorizes, without court approval, the post-petition "retention" or "replacement" of professional persons that were employed pre-petition by the debtor "on salary."[2] Section 327(b) provides that

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[1] 11 U.S.C. §§ 101–1330 (2000).
[2] 11 U.S.C. § 327(b) (2000).

> [i]f the trustee is authorized to operate the business of the debtor under section . . . 1108 of this title, and if the debtor has regularly employed attorneys, accountants, or other professional persons on salary, the trustee may retain or replace such professional persons if necessary in the operation of such business.[3]

Section 327(b) is a reflection of the change under the Bankruptcy Code of 1978 from the prior practice under the former Bankruptcy Act of 1898 (repealed 1978) where the bankruptcy court was involved in the day-to-day administration of a debtor's estate.[4]

Section 327(b) applies to the debtor in possession's continued employment of management in the ordinary course, such as its officers and directors.[5] Section 327(b) only encompasses the employment of individuals serving as officers or directors "on salary" as opposed to the retention of independent contractors.[6]

"Salary" is generally defined as follows:

> A reward or recompense for services performed. In a more limited sense a fixed periodical compensation paid for services rendered; a stated compensation, amounting to so much by the year, month, or other fixed period, to be paid to . . . persons in some private employments, for the . . . rendering of services of a particular kind, more or less definitely described, involving professional knowledge or skill, or at least employment above the grade of menial or mechanical labor. A fixed, annual, periodical amount payable for

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[3] *Id*.

[4] *See In re* All Seasons Indus., Inc., 121 B.R. 822, 825–26 (Bankr. N.D. Ind. 1990) (noting that in adopting Bankruptcy Code, role of bankruptcy judge was restricted in dealing with "administration of estate"); *In re* Zeus America Mgmt. Consultants, Inc., 27 B.R. 853, 854 (Bankr. N.D. Ohio 1983) (stating that Bankruptcy Code shifted what were previously court duties to trustee); *In re* Lyon & Reboli, Inc., 24 B.R. 152, 154 (Bankr. E.D.N.Y. 1982) (noting that in drafting Bankruptcy Code, "Congress made a conscious effort to separate bankruptcy courts from the day-to-day operations . . . .").

[5] *See In re* Madison Mgmt. Group, Inc., 137 B.R. 275, 283 (Bankr. N.D. Ill. 1992) ("Officers and employees of the debtor are usually not 'professionals,' for the purpose of section 327[a] of the Bankruptcy Code, and thus, their employment is not subject to court approval."); *In re All Seasons Indus., Inc.*, 121 B.R. at 826 ("[C]ontinued employment and compensation of management constitutes a part of the ordinary course of the debtor's business operations, which it is entitled to continue without court approval."); *In re* Bartley Lindsay Co., 120 B.R. 507, 511 (Bankr. D. Minn. 1990) ("[O]fficers and other employees are ordinarily not professional persons and therefore are not subject to the requirements of section 327."), *aff'd*, 137 B.R. 305 (D. Minn. 1991); *In re* Media Cent., Inc., 115 B.R. 119, 123 (Bankr. E.D. Tenn. 1990) ("[T]rustee . . . may operate the debtor's business. . . ."); *see also* 11 U.S.C. § 1108 (2000) ("Unless the court, on request of a party in interest and after notice and a hearing, orders otherwise, the trustee may operate the debtor's business."); 11 U.S.C. § 1107(a) (2000) ("[D]ebtor in possession shall have all the rights . . . and powers . . . of a trustee serving in a case under this chapter."); 11 U.S.C. § 363(c)(1) (2000)

> If the business of the debtor is authorized to be operated under section . . . 1108 . . . of this title and unless the court orders otherwise, the trustee may enter into transactions . . . in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing. *Id*.

[6] *See In re* Yuba Westgold, Inc., 157 B.R. 869, 872 (Bankr. N.D. Iowa 1993) (explaining exception to section 327(b) allows for debtor to retain pre-petition "in-house" professionals); *see also In re* Rusty Jones, Inc., 109 B.R. 838, 843 (Bankr. N.D. Ill. 1989) (finding three individuals not "on salary" were not within purview of section 327(b)); *In re* Carolina Sales Corp., 45 B.R. 750, 753 (Bankr. E.D.N.C. 1985) (finding company was not included in exemption because it was not on regular salary).

> services and depending upon the time of employment and not the amount of services rendered. It is synonymous with "wages," except that "salary" is sometimes understood to related to compensation for . . . other services, as distinguished from "wages," which is the compensation for labor.[7]

The section 327(b) requirement that the professional person must be employed "on salary" implies that professional persons within the purview of section 327(b) must be individuals directly employed by the debtor in possession. Where an individual management consultant is employed as an officer or director of the debtor in possession, the individual's engagement should fall within the purview of section 327(b). For example, in *In re Phoenix Steel Corp.*, the bankruptcy court held that a debtor in possession could employ pre-petition workout specialists as post-petition replacement officers under the direction of the debtor in possession's board of directors pursuant to section 327(b).[8]

The retention of a management company, as opposed to the employment of one of its principals, as an officer or director of a debtor in possession involves a more difficult question.[9] A management company is not eligible for employment under section 327(b) because it is not an individual employed "on salary." A management company, however, may be eligible for employment under section 327(a). To that end, one must first address whether a management company is a "professional person" for purposes of section 327(a). If so, one must then address whether the management company is "disinterested" as required by section 327(a). If the management is not disinterested, one must consider whether section 1107(b) excuses the management company's lack of disinterestedness.

II. EMPLOYMENT OF "PROFESSIONAL PERSONS" UNDER SECTION 327(A) IN GENERAL

Section 327(a) authorizes a trustee, with court approval, to "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."[10] Section 101(41) defines "person," in relevant part, as

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[7] BLACK'S LAW DICTIONARY 1503 (4th ed. 1968) (citations omitted). *See generally* MCI Telecomm. Corp. v. AT&T Co., 512 U.S. 218, 228 (1994) (stating dictionaries at time of enactment of statute, and not dictionaries published thereafter, are relevant sources for defining terms); Perrin v. U.S., 444 U.S. 37, 42 (1979) ("A fundamental canon of statutory construction is that, unless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning.").

[8] 110 B.R. 141, 142 (Bankr. D. Del. 1989) (designating "workout specialists" as professionals was "of no consequence" to their employment as officers under section 327(b)).

[9] *See generally In re Rusty Jones, Inc.*, 109 B.R. at 844 ("Court must consider whether there is any difference in the three men serving personally rather than through their management company.").

[10] 11 U.S.C. § 327(a) (2000); *see also* 11 U.S.C. § 103(a) (2000) ("Chapters 1, 3, and 5 of this title apply in a case under chapter 7. . . [or]. . . 11 . . . of this title."); 11 U.S.C. § 1107(a) ("Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers . . . of a trustee serving in a case under this chapter."); S. REP. NO. 95-989, at 38 (1978) (noting trustee's authority to employ disinterested professional persons); S. REP. NO. 95-989, at 116 (1978) (noting section 1108 permits debtor to continue operating its business unless otherwise provided by court order); H.R. REP. NO. 95-595 at 328 (1977) (noting trustee's

including an "individual, partnership and corporation."[11] Section 101(9), in turn, defines a "corporation" as including a corporation, a partnership (except a limited partnership), an unincorporated company or association, or a business trust.[12] Thus, an individual or a "corporation" may be employed as a "professional person" under section 327(a).

III. SCOPE OF THE TERM "PROFESSIONAL PERSONS" FOR PURPOSES OF SECTION 327(A)

The Bankruptcy Code does not define the term "professional person" utilized in section 327(a). Section 327(a) offers only the examples of "attorneys, accountants, appraisers, [and] auctioneers."[13]

Section 327(a), however, specifically provides that professional persons within its purview "represent or assist the trustee in carrying out the trustee's duties under this title."[14] As the bankruptcy court held in *In re Metropolitan Hospital*, in order to fall within the purview of section 327(a), the person must be "*both* a professional" and "represent, or assist, the trustee in the fulfillment of [the debtor in possession's] official duties."[15] A professional that is not engaged to represent or assist a debtor in possession with respect to its duties falls outside the scope of section 327(a).[16]

A "professional" person for purposes of section 327(a) is a person "with a special knowledge and skill usually achieved by study and educational attainments whether licensed or not."[17] The "duties" of a trustee or debtor in possession in a chapter 11 bankruptcy case include accounting for all property received, examining and objecting to proofs of claim, furnishing information concerning the estate and its administration as is requested by a party in interest, filing monthly operating reports and statements of receipts and disbursements, preparing a final report and filing a final accounting of the administration of the estate, filing schedules and a statement of financial affairs, filing a plan or recommending conversion of the case

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authority to employ disinterested professional persons); H.R. REP. NO. 95-595, at 404 (1977) (noting section 1108 permits debtor to continue operating its business unless otherwise provided by court order). Pursuant to section 1107(a), a debtor in possession may also employ such "professional persons" under section 327(a). *See* 11 U.S.C. § 1107(a) (2002) ("debtor in possession shall have all the rights . . . and powers . . . of a trustee serving in a case under this chapter").

[11] 11 U.S.C. § 101(41) (2000).

[12] 11 U.S.C. § 101(9) (2000).

[13] *See* 11 U.S.C. § 327(a).

[14] *Id*.

[15] 119 B.R. 910, 915 (Bankr. E.D. Pa. 1990); *see also In re* Argus Group 1700, Inc., 199 B.R. 525, 534 n.18 (Bankr. E.D. Pa. 1996) (explaining that person's duties, not person's status, determine whether section 327(a) is applicable); *In re* That's Entertainment Marketing Group, Inc., 168 B.R. 226, 230 (N.D. Cal. 1994) (holding that person's status as "professional" is not determinative, proper inquiry is on person's duties; therefore, accountant retained as expert witness was not "professional" within purview of section 327(a)).

[16] *In re Metropolitan Hosp*., 119 B.R. at 916; *see also In re* Northeast Dairy Cooperative Federation, Inc., 74 B.R. 149, 152–53, (Bankr. N.D.N.Y. 1987) (stating that focus should be on "[r]elevance those activities have in the course of a chapter 11 proceeding.").

[17] *In re Metropolitan Hosp.,* 119 B.R. at 916; *see also In re Northeast Dairy,* 74 B.R. at 153–54 (explaining that whether or not person is licensed is not determinative for professional status, rather "it is the relevance to the estate of the services provided, rather than the qualifications of provider, which mandate compliance with Code section 327(a).").

to a case under chapter 7, and furnishing information to taxing authorities.[18] Thus, a professional person within the purview of section 327(a) is a person engaged to represent or assist the trustee or debtor in possession in performing those duties.

The courts have fashioned various tests for determining whether an entity constitutes a "professional person" whose employment must be approved by the bankruptcy court under section 327(a). Courts have applied a "quantitative" test, a "qualitative" test or some combination of both tests.[19] Under the quantitative test, an entity constitutes a "professional person" if the entity plays a central role in the administration of the debtor's bankruptcy case, rather than the day-to-day mechanics of the debtor's business.[20] Under the qualitative test, an entity constitutes a "professional person" if the entity has discretion or autonomy in some part of the administration of the debtor's estate.[21] Specific factors considered under a combination of both tests include whether the entity controls, manages, administers, invests, purchases or sells assets that are significant to the debtor's reorganization, whether the entity is involved in negotiating the terms of a plan of reorganization, whether the employment is directly related to the debtor's business operations, whether the entity is given discretion or autonomy to exercise its own professional judgment in some part of the administration of the debtor's estate, the extent of the entity's involvement in the administration of the debtor's estate, and whether the entity's service involves some degree of special knowledge or skill.[22] No one factor is dispositive.[23]

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[18] *See* 11 U.S.C. § 704 (2000) (providing duties of trustees); 11 U.S.C. § 1106(a) (2000) (same); 11 U.S.C. § 1107(a) (2000) (laying out rights, powers and duties of debtor in possession).

[19] *See In re* First Merchants Acceptance Corp., 1997 WL 873551, at *2 (D. Del. Dec. 15, 1997) (noting that courts have divided into two camps, with some utilizing qualitative analysis and others quantitative analysis); *In re* Fretheim, 102 B.R. 298, 299 (Bankr. D. Conn. 1989) (applying qualitative test); *In re* Seatrain Lines, Inc., 13 B.R. 980, 981 (Bankr. S.D.N.Y. 1981) (utilizing quantitative test).

[20] *See In re* River Ranch, Inc., 176 B.R. 603, 605 (Bankr. M.D. Fla. 1994) (finding entity was not "professional person" within meaning of section 327(a) where entity was not "employed to play a pivotal role in the reorganization process"); *In re* Pacific Forest Indus., Inc., 95 B.R. 740, 743 (Bankr. C.D. Cal. 1989) ("It is only those who deal with the actual reorganization of the debtor, rather than the ongoing business of the debtor, who are required to be employed under section 327 . . . ."); *In re Seatrain Lines, Inc.*, 13 B.R. at 981 ("[F]or the purposes of section 327(a), 'professional person' is limited to persons in those occupations which play a central role in the administration of the debtor proceeding.").

[21] *See In re First Merchants Acceptance Corp.*, 1997 WL 873551, at *2 (noting under qualitative analysis professionals are those that are given discretion or autonomy in administration of some part of debtors' estate); *In re* Neidig Corp., 117 B.R. 625, 629 (Bankr. D. Colo. 1990) (stating most common factor cited in determining whether person should be considered professional under section 327(a) is amount of autonomy or discretion such person is given by debtor or trustee in performing its services); *In re Fretheim,* 102 B.R. at 299 (defining qualitative analysis as requiring determination of whether employee has discretion or autonomy in administering debtor's estate).

[22] *See In re First Merchants Acceptance Corp.*, 1997 WL 873551, at *3 (noting various factors courts consider under differing tests); *In re* Biocoastal, 149 B.R. 216, 218 (Bankr. M.D. Fla. 1993) (indicating employees' activities that constitute whether employee is "professional"); *In re* Seiling Associates Ltd. P'ship, 128 B.R. 721, 723 (Bankr. E.D. Va. 1991) (concluding that environmental consultant was not professional, within meaning of section 327, where consultant was not employed to assist debtor with reorganization, or with sale or purchase of assets); *In re Metropolitan Hosp.*, 119 B.R. at 916 ("A professional should be considered someone with a special knowledge and skill usually achieved by study and intellectual attainments whether licensed or not.").

[23] *In re First Merchants Acceptance Corp.,* 1997 WL 873551, at *3.

IV. EMPLOYMENT OF "ORDINARY COURSE PROFESSIONALS" UNDER SECTION 363(C)(1) OF THE BANKRUPTCY CODE

Section 363(c)(1) of the Bankruptcy Code provides that,

> [i]f the business of the debtor is authorized to be operated under section . . . 1108 . . . of this title and unless the court orders otherwise, the trustee may enter into transactions, . . . in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.[24]

Thus, sections 363, 1107 and 1108 may authorize a debtor in possession to employ certain entities without court approval in the ordinary course of business, at least where such entities are not "professional persons" within the purview of section 327(a).[25] The key to determining whether a transaction is authorized under section 363(c)(1) is to determine whether the transaction is made in the "ordinary course of business."

Neither the Bankruptcy Code nor its legislative history provide a framework for analyzing whether a transaction is in the ordinary course of business. Courts, however, have developed a two-part inquiry, including a "horizontal dimension" test and a "vertical dimension" test, for determining whether a transaction is in the ordinary course of business under section 363(c)(1).[26] The horizontal dimension test focuses on whether, from an industry wide perspective, the transaction is "of the sort commonly undertaken by companies in that industry."[27] The vertical

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[24] 11 U.S.C. § 363(c)(1) (2000). Section 1108, in turn, provides that "[u]nless the court, on request of a party in interest and after a notice and a hearing orders otherwise, the trustee may operate the debtor's business." 11 U.S.C. § 1108 (2000); 11 U.S.C. § 1107(a) (2000) ("[D]ebtor in possession shall have all the rights . . . and powers . . . of a trustee serving in a case under this chapter.").

[25] *In re Sieling Assocs. Ltd. P'ship.,* 128 B.R. at 723 (indicating debtor may employ environmental toxicology consultant pursuant to sections 1108 and 363(c)(1) where consultant was not professional person under section 327(a)). Section 327(b), which permits a debtor to replace professionals on salary (such as in-house counsel or accountants), may be read in conjunction with section 363(c)(1) so that a debtor in possession can employ those professionals without court approval, so long as the terms of the employment satisfy the horizontal and vertical dimension tests. *See generally In re* D'Lites of America, Inc., 108 B.R. 352, 355 (Bankr. N.D. Ga. 1989) (finding debtor in possession's replacement of its operations, finance, marketing and accounting divisions was permissible under section 363(c)(1)); *In re* Century Investment Fund VII Ltd. P'ship, 96 B.R. 884, 893–94 (Bankr. E.D. Wis. 1989) (holding court approval not required for employment of property manager); *In re Seatrain Lines, Inc*., 13 B.R. at 981 (holding court approval not required for employment of maritime engineers).

[26] *See In re* Roth American, Inc., 975 F.2d 949, 952 (3d Cir. 1992) (noting courts have developed two part inquiry when examining if action is taken in ordinary course of business; one inquiry is called horizontal dimension test, while other is called vertical dimension test); *see also* Burlington Northern R.R. v. Dant & Russell, Inc. (*In re* Dant & Russell, Inc.), 853 F.2d 700, 704–06 (9th Cir. 1998) (applying vertical and horizontal framework to conclude debtor-in-possession's post-petitionexecution of leases was in ordinary course of business); *In re* Glosser Bros., 124 B.R. 664, 667–68 (Bankr. W.D. Pa. 1991) (applying framework to execution of licensing agreement to operate department in debtor's stores); Habinger, Inc. v. Metropolitan Cosmetic & Reconstructive Surgical Clinic, 124 B.R. 784, 786 (D. Minn. 1990) (applying framework to debtor's post-petition payments for furniture and equipment).

[27] *In re Roth American, Inc*., 975 F.2d at 953; s*ee In re* Johns-Manville, 60 B.R. 612, 618 (Bankr. S.D.N.Y. 1986) ("[T]he primary focus of the horizontal analysis is external--this business vis-a-vis similar businesses."); *In re* Waterfront Co.s, Inc. 56 B.R. 31, 35 (Bankr. D. Minn. 1985) (reasoning that raising crop would not be in ordinary course of business for widget manufacturer because that is not widget manufacturer's ordinary business).

dimension test (or creditor's expectation test) focuses on the vantage point of a hypothetical creditor and inquires whether the transaction subjects the creditor to economic risk of a nature different from those the creditor accepted when it decided to extend credit to the debtor.[28] Thus, the vertical dimension test focuses on the debtor's pre-petition conduct and practices, as well as the "changing circumstances inherent" in the hypothetical creditor's expectations.[29]

Whether a turnaround management company or consultant's employment could satisfy the horizontal test may depend on the industry. Certain industries, such as steel, retail shopping center, movie theatre, and telecommunications industries, have fallen on difficult times. It may be common for companies in those industries to engage turnaround management companies or consultants.

The retention of a turnaround management company or consultant may also satisfy the vertical test. An entity extending credit may be deemed to expect its borrower to retain a turnaround management company or consultant if the borrower's business operations begin to falter. Of course, the terms of a particular retention agreement (including indemnification and exculpation provisions beyond those authorized by applicable corporation law) may fail either or both the hypothetical and vertical tests.

Whether or not the engagement of a turnaround management company or consultant satisfies the two-part inquiry for an "ordinary course of business transaction," section 327(a) should govern the engagement. Section 327(a) is a much more specific provision than section 363(c)(1). Thus, the engagement of any turnaround management company or consultant that falls within the purview of section 327(a) must be governed by its terms.[30] Section 363(c)(1) should be interpreted to authorize the engagement of nonprofessionals or professionals that are not retained to assist the debtor in possession with carrying out its duties under title 11.

V. EMPLOYMENT OF MANAGEMENT COMPANIES AS PROFESSIONALS PERSONS UNDER SECTION 327(A)

In determining whether a turnaround management company must be disinterested, as defined in section 101(14), one must first determine whether a management company is a professional person for purposes of section 327(a). The services offered by such management companies are significantly related to

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[28] *See In re Roth American, Inc.*, 975 F.2d at 953 (noting that under vertical dimensions test inquiry is into whether transaction subjects hypothetical creditor to risk of nature different from what it expected at time it extended credit); *see also In re Johns-Manville*, 60 B.R. at 616–17 (utilizing vertical dimension or creditor's expectation test); *In re* James A. Phillips, Inc., 29 B.R. 391, 394 (Bankr. S.D.N.Y. 1983) (exploring "ordinary course of business" under vertical test); Benjamin Weintraub & Alan N. Resnick, *The Meaning of "Ordinary Course of Business" Under the Bankruptcy Code-Vertical and Horizontal Analysis*, 19 UCC L.J. 364, 365–66 (1987) (explaining vertical and horizontal tests).

[29] *See In re Roth American, Inc.*, 975 F.2d at 953 (explaining vertical dimensions test); Weintraub & Resnick, *supra* note 29, at 365–66.

[30] *See* Varity Corp. v. Howe, 516 U.S. 489, 511 (1996) (warning "[a]gainst applying a general provision when doing so would undermine limitations created by a more specific provision."); Morales v. Trans World Airlines, Inc., 504 U.S. 374, 384 (1992) ("It is a commonplace of statutory construction that the specific governs the general . . . ."); Morton v. Mancari, 417 U.S. 535, 550–51 (1974) ("Where there is no clear intention otherwise, a specific statute will not be controlled or nullified by a general one . . . .").

the administration of the estate. Although the extent of discretion and autonomy exercised by the consultant varies according to the terms of the engagement, the services provided by management companies and consultants invariably involve assisting the debtor in possession with respect to many of its duties under sections 1107 and 1106(a).[31]

"Auctioneers" and "appraisers" are sufficiently involved in administration of the debtor's estate to constitute "professional persons."[32] Comparably, services offered by management companies are as integral to the trustee's or debtor in possession's duties as services offered by auctioneers, appraiser and collection agents. For instance, management companies and consultants typically manage or assist the debtor in administering its assets and assist the debtor in negotiating the terms of a plan of reorganization.[33] Although management companies exercise varying degrees of discretion or autonomy in exercising their professional judgment, management companies and consultants provide important services that may have a significant impact on a debtor's reorganization.

In *In re Yuba Westgold, Inc.*, the United States Bankruptcy Court for the Northern District of Iowa held that an entity that the debtor sought to employ under a Management Services Agreement was a "professional person" under section 327(a).[34] The entity was to provide services including employee related services, pension plan administration, management, and supervision of consultants, assistance with an asset sale, compliance with Securities and Exchange requirements, and asset-management services.[35]

In *In re Rusty Jones, Inc*., the United States Bankruptcy Court for the Northern District of Illinois also concluded that a management company was a "professional person" under section 327(a).[36] The entity sought to provide services including "certain tasks" relating to the debtor's current operations and assurance of future viability, development of a business plan, bookkeeping and financial functions relating to receivables collection, disposal of non-essential assets, lease negotiations, and supervision of the debtor's employees.[37] Other courts agree that management companies fall within the purview of "professional persons" under section 327(a).[38] As a "professional person" under section 327(a), a management

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[31] *See In re* Yuba Westgold, Inc., 157 B.R. 869, 871 (Bankr. N.D. Iowa 1993) (explaining management company assisted with asset sales and asset-management services); *In re* Rusty Jones, Inc., 109 B.R. 838, 842–44 (Bankr. N.D. Ill. 1989) (noting management company assisted with current operation and assurance of future viability, development of business plan, receivables collection and asset disposition).

[32] *See* 11 U.S.C. § 327(a) (2000) (finding auctioneers and appraisers to be professionals). Courts have also held that collection agents are "professional persons" for purposes of section 327(a); *In re* First Merchants Acceptance Corp., 1997 WL 873551, at *4 (D. Del. Dec. 15, 1997) (likening services under consultation agreement to serviced provided by professional collection agency); *In re* Metropolitan Hosp., 119 B.R. 910, 918 (Bankr. E.D. Pa. 1990) (finding that creating and collection of post-bankruptcy receivables qualified as "professional" service within scope of section 327(a)); *see also In re* Windsor Communications Group, 68 B.R. 1007, 1012 (E.D. Pa. 1986) (noting that collection agency can be within scope of section 327(a)).

[33] *See In re Yuba Westgold, Inc*., 157 B.R. at 871 (explaining management company assisted with asset sales and asset-management services); *In re Rusty Jones, Inc*., 109 B.R. at 842–44 (noting management company assisted with development of business plan and asset disposition).

[34] 157 B.R. at 872.

[35] *Id*. at 871.

[36] 109 B.R at 842–44.

[37] *Id*.

[38] *See In re* Madison Mgmt. Group, Inc., 137 B.R. 275, 283 (Bankr. N.D. Ill. 1992) ("Generally, financial advisors,

company, or an individual consultant that is not serving as an officer or director under section 327(b), must be "disinterested" in order to be eligible for employment under section 327(a).[39]

VI. "DISINTERESTEDNESS" STANDARD UNDER SECTION 327(A)

Section 327(a) provides that a debtor in possession may employ professionals who are "disinterested" and do "not hold or represent an interest adverse to the estate."[40] Disputes concerning the employment of management companies and individual consultants under section 327(a) usually center on the "disinterested" requirement.

Section 101(14) defines a "disinterested person" as one that

> (A) is not a creditor, an equity security holder, or an insider;
> (B) is not and was not an investment banker for any outstanding security of the debtor;
> (C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such a investment banker in connection with the offer, sale, or issuance of a security of the debtor;
> (D) 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 of an investment banker specified in subparagraph (B) or (C) of this paragraph; and
> (E) 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 an investment banker specified in the subparagraph (B) of (C) of this subparagraph, or for any other reason[.][41]

VII. PRE-PETITION EMPLOYMENT OF MANAGEMENT MANAGEMENT COMPANIES AS OFFICERS OR DIRECTORS AND THE RELATED DISINTERESTEDNESS PROBLEMS

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workout specialists and consultants are, for purposes of section 327 of the Bankruptcy Code, 'professionals.'"); *In re* Saybrook Mfg. Co., 108 B.R. 366, 368 (Bankr. M.D. Ga. 1989) (finding management consultants are professionals under section 327(a)); *In re* American Int'l Airways, Inc., 69 B.R. 396, 397 (Bankr. E.D. Pa. 1987) (referring to "management consultants" as professionals for purposes of section 327(a)); *In re* Carolina Sales Corp., 45 B.R. 750, 752–53 (Bankr. E.D. Wis. 1985) (finding that management consultants were "professional persons"); *see also In re* Marion Carefree Ltd. P'ship, 171 B.R. 584, 588–89 (Bankr. N.D. Oh. 1994) (stating "manager" was professional person under section 327(a) where manager had significant responsibility and discretion in personnel management and performed general accounting, payroll accounting, and cash management functions that played important role in providing estate with financial data).

[39] 11 U.S.C. § 327(a) (2000) (stating "professionals" must be "disinterested persons").

[40] 11 U.S.C. § 327(a).

[41] 11 U.S.C. § 101(14) (2000). The definition of "disinterested person" is adapted from section 158 of chapter X of the former Bankruptcy Act (repealed 1978), though it is "expanded and modified in some respects." *See* S. REP. NO. 95-989, at 23 (1978); H.R. REP. NO. 95-595, at 310 (1977).

The terms of the employment agreement between a debtor in possession and turnaround management consulting firm must be carefully structured and drafted to avoid rendering the management company interested and, therefore, ineligible for employment under section 327(a) of the Bankruptcy Code.

A. "Creditor" or "Equity Security Holder" under sections 101(14)(A)

If a management company or individual consultant is a "creditor" or "equity security holder" of the debtor in possession, the management company or individual consultant is not "disinterested" as defined in section 101(14) for the purposes of section 327(a). The terms "creditor" and "equity security holder" are defined in sections 101(10) and 101(17) of the Bankruptcy Code.[42] A "creditor" is an entity that holds a "claim" that "arose at the time of or before the order for relief" against the debtor's estate.[43] An "equity security holder" is an entity that holds a residual interest, such as stock or a warrant to purchase stock, in the debtor.[44] Where a management company or consultant holds a pre-petition claim against the debtor's estate or an equity interest in the debtor, the management company or consultant is not "disinterested" under section 101(14)(A) and may not be employed under section 327(a).[45]

A management agreement, whether pre-petition or post-petition, must be drafted to avoid compensating the management company or consultant with any equity interest in the debtor. In addition, where a debtor engages a management company prior to filing a bankruptcy petition, the debtor should ensure that the management company does not hold a claim against the debtor as of the petition date. The best way of ensuring that the management company does not hold a claim is to prepay the management company for its services. Substantial preferential payments on account of antecedent debt prior to the filing of the debtor's bankruptcy petition would render the management company ineligible for employment.[46]

One way in which a management company may unwittingly become a "creditor" is by inserting indemnification provisions in their engagement agreements. As the Third Circuit has held, "[w]hen parties agree in advance that one party will indemnify the other party in the event of a certain occurrence, there

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[42] 11 U.S.C. § 101(10) (2000) (defining "creditor"); 11 U.S.C. § 101(17) (2000) (defining "equity security holder").

[43] *See* 11 U.S.C. § 101(10) (defining "creditor"); 11 U.S.C. § 101(5) (2000) (defining "claim").

[44] *See* 11 U.S.C. § 101(16) (2000) (defining "equity security"); 11 U.S.C. § 101(17) (defining "equity security holder"); Apex Mgmt. Corp. v. WSR Corp., 225 B.R. 640, 645 (N.D. Ill. 1998) (finding shareholder in debtor company was equity security holder).

[45] *See In re* Pillowtex, Inc., 304 F.3d 246, 253 n.5 (3d Cir. 2002) (stating "creditor" is not disinterested under section 101(14)); United States Trustee v. Price Waterhouse, 19 F.3d 138, 142 (3d Cir. 1994) (finding creditor accounting firm not disinterested); *In re* Yuba Westgold, 157 B.R. 869, 872 (Bankr. N.D. Iowa 1993) (holding management company that was "creditor" was not disinterested).

[46] *See In re Pillowtex, Inc.*, 304 F.3d at 252 n.4, 224 (explaining bankruptcy court must determine whether professional received substantial preference before approving employment of professional as substantial preference liability will result in professional having materially adverse interest to class of creditors under section 101(14)(E), thereby rendering professional ineligible for employment under section 327(a)); *In re* First Jersey Securities, Inc., 180 F.3d 504, 509 (3d Cir. 1999) (finding professional's receipt of preferential payment under section 547 gives rise to actual conflict of interest thereby disqualifying professional from employment under section 327(a)).

exists a right to payment, albeit contingent" and, therefore, a "claim."[47] Even where the engagement agreement does not contain a right of indemnification, a management company serving as an "officer" or "director" may constitute a "creditor" because it holds a contingent claim for indemnification under a corporation's bylaws.[48]

If the management company or consultant is a "creditor" because it holds a pre-petition claim against the debtor in possession's estate, the management company or consultant may be able to waive the claim and thereby render itself disinterested as required by section 327(a). Some courts have allowed professional persons to waive their claims and thereby become eligible for employment under section 327(a).[49]

Obtaining an indemnification provision in a post-petition engagement agreement that protects the management company from pre-petition claims may not make the management company a "creditor," which by definition holds a pre-petition claim. One commentator has stated that a post-petition agreement providing a professional person with a right of indemnity with respect to pre-petition acts may create a *post*-petition administrative expense claim.[50] However, where the indemnitee also has a pre-petition right of indemnity, it is not clear whether the courts would hold that the inclusion of the indemnity provision concerning pre-petition conduct in a post-petition contract, by itself, makes the indemnity claim a post-petition claim. A court may hold that a claimant has one claim, with both a pre-petition and post-petition theory to recover the claim.[51] Assuming, however, that a post-petition contractual indemnity claim for pre-

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[47] Avellino & Bienes v. M. Frenville Co., Inc. (*In re* M. Frenville Co., Inc.), 744 F.2d 332, 336 (3d Cir. 1984) (stating indemnity clause creates contingent right to payment), *cert. denied sub nom.*, M. Frenville Co. v. Avellino & Bienes, 469 U.S. 1160 (1985); *see In re* Amfesco Indus., Inc., 81 B.R. 777, 781 (Bankr. E.D.N.Y. 1988) (stating that contingent right to indemnity creates claim); *see also In re* Consolidated Oil & Gas, Inc., 110 B.R. 535, 538 (Bankr. D. Colo. 1990) (holding that although duty to indemnify arose post-petition, such indemnification was pre-petition claim as actions necessitating such claim of indemnification occurred pre-petition).

[48] *See In re* Mid-American Waste Sys., Inc., 228 B.R. 816, 821–22 (Bankr. D. Del. 1999) (stating indemnity claim pursuant to bylaws for pre-petition actions constituted pre-petition claim); *In re Consolidated Oil & Gas, Inc.*, 110 B.R. at 538 (holding that although duty to indemnify arose post-petition, such indemnification was pre-petition claim, as actions necessitating such claim of indemnification occurred pre-petition); *see also In re* Philadelphia Mortgage Trust, 117 B.R. 820, 828 (Bankr. E.D. Pa. 1990) (reasoning that indemnity claims arising from corporate bylaws are consistently denied administrative status due to fact that they are pre-petition claims).

[49] *See In re* LKM Indus., Inc., 252 B.R. 589, 595 (Bankr. D. Mass. 2000) (holding that professional person could not be employed under section 327 absent waiver of claim); *In re* Watervliet Paper Co., 111 B.R. 131, 133 (W.D. Mich. 1989) (stating bankruptcy court properly required waiver of claim before approving engagement of professional person under section 327); *see also In re* Princeton Medical Mgmt. Inc., 249 B.R. 813, 816 (Bankr. M.D. Fla. 2000) (providing professional person could not be employed under section 327 where professional proposed to subordinate, rather than waive, his claim); *In re* Marion Carefree Ltd. P'ship., 171 B.R. 584, 590 (Bankr. N.D. Ohio 1994) (stating professional person could not be employed under section 327 where professional proposed to waive its claim at some future time).

[50] *See* Martin J. Bienenstock, *Once in Chapter 11, Whose Company Is It Anyway?*, 573 P.L.I. COMM. 667, 687 (1991).

[51] *See In re* Pinnacle Brands, Inc., 259 B.R. 46, 51 (Bankr. D. Del. 2001) (explaining indemnitee claiming both pre-petition indemnitee claim under bylaws and post-petition common law indemnitee claims with respect to pre-petition conduct has pre-petition claim). *See generally In re* Christian Life Ctr., 821 F.2d 1370, 1374 (9th Cir. 1987) (stating "critical fact" rendering officer's indemnity claim to be pre-petition claim was that claim for indemnity originated out of pre-petition services); *In re* Heck's Prop., Inc., 151 B.R. 739, 768 (S.D. W. Va. 1992) (providing indemnity claim pursuant to articles of incorporation for post-petition conduct is entitled to administrative priority). Accordingly, the management company should waive any pre-petition claim for indemnity.

petition actions is a post-petition claim, the management company would not fail to be disinterested as a "creditor" as a result of the indemnity claim.

B. "Officer" or "Director" under sections 101(14)(A) and (D) and section 101(31)(B)(i) and (ii)

Where a management company constitutes an "insider" under section 101(14)(A) of the Bankruptcy Code, the management company is not "disinterested" as required by section 327(a).[52] In determining whether a management is an "insider," one must turn to the definition of "insider." Where the debtor is a corporation, section 101(31) defines an "insider" as including, *inter alia* "directors" and "officers" of the debtor.[53]

In addition to the fact that a current officer or director is ineligible for employment by a debtor in possession under section 327(a), section 101(14)(D) further precludes employment under section 327(a) of a professional person who formerly served as an officer or director of the debtor within two years prior to the filing of the bankruptcy petition.[54]

Individual management consultants may be employed as officers or directors under section 327(b).[55] In that capacity, the individual management consultants would not be "professional persons" for purposes of section 327(a).[56] The individual management consultants would not have to demonstrate that they are "disinterested," as employment under section 327(b) does not require such a showing.[57]

On the other hand, management companies performing their typical services are "professional persons" under section 327(a). As a professional person under section 327(a), a management company must demonstrate that it is "disinterested" under section 327(a).[58] Often the contract between a debtor or a debtor in possession and a management company provides that the management company, rather than any individual consultant, will serve as an officer or director of a debtor or debtor in possession. Where the management company was engaged as the

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[52] 11 U.S.C. § 101(14)(A) (2000) (stating "disinterested person" does not include "insider").

[53] *See* 11 U.S.C. § 101(31)(B)(i) (2000) (providing "director" is insider); 11 U.S.C. § 101(31)(B)(ii) (2000) (providing "officer" is insider).

[54] *See* 11 U.S.C. § 101(14)(D) (2000) (stating person is not disinterested if she served "within two years before the date of the filing of the petition, [as] a director, officer, or employee of the debtor . . . ."); *see also* 11 U.S.C. § 101(14)(A) (stating "insider" is not "disinterested"); 11 U.S.C. § 101(31)(B)(i) (stating "director" is an "insider"), 11 U.S.C. § 101(31)(B)(ii) (stating "officer" is an "insider").

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

[56] *Id.*

[57] *See In re* Bartley Lindsay Co., 120 B.R. 507, 513 (Bankr. D. Minn. 1990) ("[O]fficers and other employees are ordinarily not professional persons and therefore are not subject to the requirements of section 327"), *aff'd*, 137 B.R. 305 (D. Minn. 1991); *In re* Dola Int'l Corp., 88 B.R. 950, 955 (Bankr. D. Minn. 1988) (finding debtor in possession is not required to seek court approval under section 327 to retain salaried officers).

[58] *See* Committee v. ABC Capital Mkts. Group and Capitol Metals Co., Inc. *(In re* Capitol Metals Co.), 228 B.R. 724, 726 (B.A.P. 9th Cir. 1998) ("Among the requirements for employment is that the professional is a 'disinterested person'"); *In re Bartley Lindsay Co.*, 120 B.R. at 511 (stating requirement that professional person must be "disinterested" under section 327(a)).

debtor's officer or director, the management company is ineligible for post-petition employment as it is not "disinterested" as required by section 327(a).[59]

The effect of improperly structuring the engagement of a turnaround management company as an "officer" or "director" was evident in *In re Bartley*.[60] In that case, the bankruptcy court acknowledged that financial advisors, workout specialists, and consultants are generally professionals for the purposes of section 327(a).[61] The court also acknowledged that "officers" and other employees are ordinarily not professional persons subject to the requirements of section 327(a).[62] The court, however, had difficulty in applying those principles where a management consulting firm was retained by the debtor and agreed to provide one of its employees to serve as an officer of the debtor in possession.[63]

The bankruptcy court stated that a decision needed to be made "about who was being employed for what purposes, under what arrangement, and under what form."[64] The court started with the proposition that substance, rather than form, was determinative.[65]

The court rejected the argument that the mere fact the individual performed his services in the role of president and chief executive officer insulates him from the requirements of section 327(a).[66] Likewise, the court rejected the argument that the mere fact the individual's main profession is that of a management consultant and workout specialist means that section 327(a) applies even where the individual is employed as president and chief executive officer.[67]

The bankruptcy court listed the following factors as helpful in determining whether section 327(a) is applicable:

> (1) What duties are being performed by the individual officer? Is the officer performing traditional executive functions of the office held or is the officer performing services in the way of advice and consulting services for the debtor which is beyond the traditional function of the office held or both?
> (2) Is former management still employed by the company or have one or more executives left, leaving a gap in management?
> (3) Is the officer, in fact, making those executive decisions traditional of the office held and directing others or are others actually making the decisions based on the advice from the officer?
>
> (4) Is the officer's primary employment the provision of consulting workout or other insolvency services to distressed

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[59] *See* 11 U.S.C. § 101(14)(A) (stating "officer" or "director" is not "disinterested person").
[60] 120 B.R. at 507.
[61] *Id*. at 511.
[62] *Id*.
[63] *Id*. at 512–13.
[64] *Id*. at 511–12.
[65] *In re Bartley Lindsay Co.*, 120 B.R. at 512.
[66] *Id*.
[67] *Id*.

> businesses or is the officer a corporate executive by training and profession?
> (5) Is compensation for the officer's services paid directly to the officer or is it paid to another legal entity by which the officer is also employed?
> (6) Does the officer receive fringe benefits and other perquisites of the office held consistent with the treatment of other similarly situated and former officers and employees?
> (7) Are income and employment taxes withheld from the officer's compensation or is the amount of gross compensation paid to the officer or to some other entity?
> (8) Is the compensation of the officer consistent with compensation paid to predecessors and with others employed by the debtor? In other words, is the compensation so large and out of proportion to other compensation being paid by the debtor that such payment would be considered to be outside the ordinary course of the debtor's business?
> (9) Has the officer been employed specifically to work through and try and solve the debtor's financial problems or is the employment permanent or intended as indefinite?
> (10) Does the officer's employment antedate the commencement of the bankruptcy case or is it contemporaneous with or following commencement of the bankruptcy case?
> (11) Is the officer working full time for the debtor or is the officer allowed to perform services for other business as well?
> (12) Is the officer or the officer's firm paid a retainer?[68]

Although the court believed that the record was void with respect to certain of those issues, they concluded that the individual was acting as a professional person during the time he worked for the debtor.[69]

By profession, the individual was a workout consultant. While the debtor's board of directors elected the individual as its president and chief executive officer, it never employed him. The only outstanding contract was between the debtor and the management company that employed the individual.[70] The services provided by the management company included the individual's services as president and chief executive officer.[71] The debtor paid the management company a retainer, something commonly associated with the retention of professionals, but not with the employment of employees. The debtor did not employ, contract with, or pay the individual.[72] The bankruptcy court concluded both the individual and the management company were "professional persons" for the purposes of section 327(a).[73]

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[68] *Id*.
[69] *Id*. at 512–13.
[70] *In re Bartley Lindsay, Co*., 120 B.R. at 513.
[71] *Id*.
[72] *Id*.
[73] *Id*. at 513.

The fact that the management company, rather than the individual, contracted with the debtor essentially meant that the management company was providing the services of president and chief executive officer through its employees.[74] As an "officer" of the debtor, the management company was not disinterested under section 101(14)(D) and 101(14)(A) and 101(31)(B)(ii) and, therefore, was ineligible for employment under section 327(a).[75]

If the individual serving as president and chief executive officer contracted with the debtor in possession to serve in such capacities, the individual's retention may have fallen within the purview of section 327(b), rather than section 327(a). No court approval would have been necessary to employ the individual on salary under section 327(b). In addition, the management company may have been disinterested and eligible for employment under Section 327(a), as it was not serving as an "officer" of the debtor in possession.

Similarly, in *Committee v. ABC Capital Markets Group (In re Capital Metals Co.)*, the management company entered into a pre-petition consulting agreement with the debtor.[76] Pursuant to the consulting agreement, the debtor hired the management company to serve as its chief financial officer.[77] As a result of the structure of that agreement, the management company rendered itself ineligible for post-petition employment as an "officer," an "insider" and, therefore, was not a disinterested person.[78]

The structure of the retention of management companies often follows the structure employed in *Bartley* and *Capitol.* The management company is engaged as an "officer" or "director" of the debtor in possession. The management company is also retained as a consultant. The management company designates one or more individual consultants to provide services as the debtor's officer or director. That structure is a bad choice of form, as the management company is an "insider" under section 101(31)(B)(i) or (ii) and is not eligible to be retained post-petition as a consultant because they are not "disinterested" under sections 327(a) and 101(14)(A) and (D).[79]

C. "In Control" Under section 101(31)(B)(iii)

Disputes concerning employment of management companies may also focus on whether the management company is a "person in control" or "managing agent" of the debtor in possession.[80] Whether the management company is a

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[74] *Id.* In drawing its conclusion the court took note of the fact that although consultant served as president and chief executive officer, debtor in possession never employed or paid him, but rather employed and paid his management consulting firm.

[75] *In re Bartley Lindsay, Co*., 120 B.R. at 513; 11 U.S.C. § 101(14)(A) (2000) (stating "disinterested person" does not include "insider").

[76] Committee v. ABC Capital Mkts. Group and Capitol Metals Co., Inc. (*In re* Capitol Metals Co.), 228 B.R. 724 (B.A.P. 9th Cir. 1998).

[77] *Id*. at 725.

[78] *Id*. at 727.

[79] *Id*. at 726–27.

[80] *See* 11 U.S.C. § 101(14)(A) (stating "insider" is not disinterested); 11 U.S.C. § 101(31)(B)(iii) (2000) (providing "person in control of debtor" is an "insider"); 11 U.S.C. § 101(31)(E) (2000) (explaining "managing agent" of debtor is "insider").

"person in control" of the debtor may depend upon the terms of the engagement, or the actual control exercised by the management company. Where a management company does not have authority to direct corporate officers or to dictate corporate policy, the management company may not be "in control" of the debtor in possession. A management company that is only operating in the capacity of a consultant to the debtor in possession's management does not thereby obtain control of the debtor in possession. The management company should not be deemed an "insider," and should be eligible for retention by the debtor in possession under section 327(a).

A management company that has authority to direct corporate officers or to dictate corporate policy under the terms of the engagement would be "in control" of the debtor in possession. The management company therefore would be an "insider" under section 101(14)(A), would not be "disinterested," and would be ineligible for retention under section 327(a).

In *In re Sullivan Haas Coyle, Inc*., the bankruptcy court considered whether a management company was a "person in control" of the debtor in possession under section 101(31)(B)(iii).[81] The court stated that a "high degree of control," such as a controlling interest or ability to exercise sufficient authority over the debtor so as to "dictate corporate policy and the disposition of assets" was necessary to render a person "in control" of the debtor in possession.[82] Applying those factors to the case before it, the court concluded the management company was not "in control" of the debtor in possession. Although the management company was involved in the day-to-day decisions regarding the management of the debtor's cash position, the management company did not have a "stranglehold" over the debtor in possession.[83] The debtor in possession was free to act independently and to terminate the management company at any time.[84] The management company had no authority to dictate corporate policy, as the debtor in possession's officers made all final decisions.[85] Further, the management company did not have authority to dispose of corporate assets or to determine the actual operation of the debtor in possession's business.[86] Therefore, the court concluded that the management company was engaged "simply as a consultant to give advice on financial matters."[87]

In order to avoid unnecessarily creating disinterestedness issues, an engagement agreement between a debtor or debtor in possession and a management company should clearly provide that the directors dictate corporate policy and the officers make final decisions with respect to the day-to-day operations of the business. The role of management consultants should be advisory to ensure that the management company remains disinterested and eligible for employment under section 327(a).

D. "Managing Agent" under section 101(31)(E)

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[81] 208 B.R. 239 (Bankr. M.D. Ga. 1997).
[82] *Id*. at 243.
[83] *Id*.
[84] *Id*. at 243–44.
[85] *Id*. at 244.
[86] *In re Sullivan Haas Coyle, Inc.*, 208 B.R. at 244.
[87] *Id*.

A professional person that is a "managing agent" for a debtor is also an "insider" under section 101(31)(E) and, therefore, is not "disinterested" under sections 327(a) and 101(14)(A).[88] Although a management agreement should be drafted to avoid rendering the management company to be a "managing agent," the Bankruptcy Code does not define the term "managing agent."[89] The legislative history accompanying section 101(14) also offers no guidance on the meaning of that term.

In *Field v. Mans*, the Supreme Court declared the utilization in the Bankruptcy Code of a term with an established meaning was meant to "incorporate the general common law" or the "the dominant consensus of common-law jurisdictions, rather than the law of any particular State" as of the time the Bankruptcy Code was enacted.[90] The Supreme Court turned to the Restatement of Torts as the most widely accepted distillation of the common law to determine the settled meaning of "fraud" in 1978 when that term was employed in the Bankruptcy Code.[91] There is no Restatement of the law concerning the term "managing agent." There are, however, compilations of the general common law as of 1978 in Black's Law Dictionary.

The edition of Black's Law Dictionary that was in effect, when the Bankruptcy Code was enacted in 1978,[92] defined "managing agent," in relevant part, as follows:

> A person who is invested with general power, involving the exercise of judgment and discretion, as distinguished from an ordinary agent or employee, who acts in an inferior capacity, and under the direction and control of superior authority, both in regard to the extent of the work and the manner of executing the same.[93]

This definition of "managing agent" is consistent with other examples of relationships giving rise to "insider" status.[94] Each of those other examples of "insider" status involve positions or relationships in which one could exert control or influence over the debtor.[95] As statutory construction is a holistic endeavor, the

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[88] 11 U.S.C. § 101(31)(E) (2000) (providing "managing agent" is "insider"); 11 U.S.C. § 101(14)(A) (2000) (stating "disinterested person" is not "insider").

[89] *See In re* City of Columbia Falls, 143 B.R. 750, 764–65 (Bankr. D. Mont. 1992) (stating that term "managing agent" is not defined under Bankruptcy Code); *In re* Polk, 125 B.R. 293, 295-96 (Bankr. D. Colo. 1991) (explaining that "insiders" is not clearly defined and includes "managing agents" under 11 U.S.C. § 101(30)(f)); *In re* Standard Stores, Inc., 124 B.R. 318, 323 (Bankr. C.D. Cal. 1991) (noting term "managing agent" is ambiguous and is not defined in Bankruptcy Code).

[90] Field v. Mans, 516 U.S. 59, 71 n.9 (1995).

[91] *Id.* at 70–73.

[92] The dictionaries at the time a statute is enacted, and not dictionaries published thereafter, are the relevant sources for defining terms. MCI Telecomm. Corp. v. AT & T, 512 U.S. 218, 228 (1994); Perrin v. United States, 444 U.S. 37, 42 (1979) ("[W]e look to the ordinary meaning of the term . . . at the time Congress enacted the statute . . . .").

[93] BLACK'S LAW DICTIONARY 1112, 86 (4th ed. rev. 1968) (citations omitted).

[94] *See In re Standard Stores, Inc.*, 124 B.R. at 323–24 ("[D]efinition of 'managing agent' is consistent with the principal design of section 101(30) and does not overlap or conflict with the categories of insiders expressly described in the preceding subsections of" section 101(30)).

[95] *See* Torcise v. Cunigan, 146 B.R. 303, 305 (Bankr. S.D. Fla. 1992) ("[An] insider is one who has a sufficiently

definition of "managing agent" should be consistent with the definitions of those other examples of "insider" status.[96]

Congress does not write on a clean slate when it amends the bankruptcy laws.[97] Thus, the Supreme Court has instructed bankruptcy courts to interpret the Bankruptcy Code as continuing the law under the former Bankruptcy Act (repealed 1978) where Congress has not clearly expressed an intent to change the law under the Bankruptcy Code.[98]

The term "managing agent" was not employed in the former Bankruptcy Act (repealed 1978). The term, however, was often used to describe persons with significant control of a debtor or its property. For example, real property managers and persons in control of businesses have been described as "managing agents."[99] The general understanding of the term "managing agent" under the

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close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms length with the debtor.") (quoting H.R. Rep. No. 95-595, at 312 (1977)); *In re* City of Columbia Falls, 143 B.R. 750, 764 (Bankr. D. Mont. 1992) ("[T]ests developed by the court in determining who is an insider focus on the closeness of the parties and the degree to which the transferee is able to exert control or influence over the debtor.") (quoting Miller v. Schuman (*In re* Schuman), 81 B.R. 583, 586 (B.A.P. 9th Cir. 1987)); *In re Standard Stores*, *Inc.*, 124 B.R. at 323 ("The focus of nearly all the subdivisions of section 101(30) is on those entities that exert or could exert control or influence over the debtor.").

[96] *See generally* United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 371 (1988) ("Statutory construction . . . is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme . . . because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law . . . ."); Atlantic Cleaners & Dyers, Inc. v. United States, 286 U.S. 427, 433 (1932) ("[T]here is a natural presumption that identical words used in different parts of the same act are intended to have the same meaning.").

[97] Dewsnup v. Timm, 502 U.S. 410, 419 (1992); *see* Emil v. Hanley, 318 U.S. 515, 521 (1943) (stating that proviso in Bankruptcy Act was not written over clean slate); Nostas Assocs. v. Costich (*In re* Klein Sleep Prods.), 78 F.3d 18, 27 (2d Cir. 1996) (concluding in relation to amending Bankruptcy Act that "[w]e are not . . . permitted to start from scratch.").

[98] *See Dewsnup*, 502 U.S. at 419 ("[T]his Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history."); Pa. Dep't. of Public Welfare v. Davenport, 495 U.S. 552, 563 (1990) (stating that Bankruptcy Code does not do away with past bankruptcy practice unless that intention is clearly evidenced); United States v. Ron Pair Enterp., Inc., 489 U.S. 235, 244–45 (1989) (concluding that departure from pre-Code practice requires congressional intent); *United Sav. Ass'n*, 484 U.S. at 380 (opining that Congress would not revoke any pre-Code entitlement without indication of intent in legislative history); Kelly v. Robinson, 479 U.S. 36, 47 (1986) (stating Court previously declined to hold that Code took away exception in Act); Midlantic Nat'l Bank v. N.J. Dep't. of Envtl. Prot., 474 U.S. 494, 501 (1986) (concluding that specific congressional intent is needed to change interpretation of judicially created concept).

[99] *See In re* Palomna Estates, 126 F.2d 72, 74 (2d Cir.) (referring to real property manager as managing agent), *cert. denied*, 317 U.S. 684 (1942); Brislin v. Killanna Holding Corp., 85 F.2d 667, 670 (2d Cir. 1936) (citing same proposition); Manchester Mill & Elevator Co. v. Strong, 231 F. 876, 881 (8th Cir. 1916) (explaining that individual, who was president and chief executive officer, was "held out as a managing agent in sole charge of the business of the company"). The term "managing agent" as utilized in the Federal Rules of Civil Procedure has also been interpreted as denoting a person with control over a business entity. *See* Founding Church of Scientology of Washington, D.C., Inc. v. Webster, 802 F.2d 1448, 1452–53 (D.C. Cir. 1986) (noting that determining whether person is "managing agent" begins with assessment of character of individual's control), *cert. denied*, 484 U.S. 871 (1987); Crimm v. Missouri Pacific R.R. Co., 750 F.2d 703, 708-09 (8th Cir. 1984) (discussing that "managing agent" determined by extent of power and discretion over corporate matters); Pietrucha v. Grant Hosp., 447 F.2d 1029, 1035 (7th Cir. 1971) (explaining that "managing agent" has "general powers to exercise his discretion and judgment in dealing with corporate matters"); Skogen v. Dow Chem. Co., 375 F.2d 692, 701 (8th Cir. 1967) (stating that "managing agent" acts with "superior authority and general autonomy" and has power to exercise its discretion); McDonald v. United States, 321 F.2d 437, 441 (3d Cir. 1963) (noting that individual was not "managing agent" where individual had no supervisory authority and acted under supervision and direction of superior), *cert. denied*, 375 U.S. 969 (1964); *cf.* Glovatorium, Inc. v. NCR Corp., 684 F.2d 658, 662 (9th Cir. 1982) (providing that under California law, "managing agent" has discretion to make decisions that will ultimately determine corporate policy).

common law, and as utilized in bankruptcy cases under the former Bankruptcy Act (repealed 1978), denote persons with control of the debtor or its assets. Courts that have explicitly interpreted the term "managing agent" in section 101(14)(A) of the Bankruptcy Code have not relied upon the common law meaning of that term as it existed in 1978 or the meaning of that term in case law under the former Bankruptcy Act (repealed 1978). Those courts nevertheless have interpreted "managing agent" as involving a relationship where a person has control of the debtor in possession or its property.

For example, in *In re Standard Stores, Inc*., the bankruptcy court considered whether the debtor's general manager was a "managing agent" under section 101(31)(E).[100] The general manager did not have the authority to pay or direct the payment of obligations.[101] He could not hire or fire store managers without the approval of other individuals,[102] nor could he order supplies.[103]

Noting the Bankruptcy Code's absence of a definition of "managing agent," the bankruptcy court held that the term should be interpreted in a manner consistent with other examples of "insiders."[104] The court concluded that "managing agent" refers

> to those entities that exert or could exert operational control over a debtor, a division or unit of a debtor, or a significant portion of a debtor's property. Such operational control would ordinarily include the ability to make personnel decisions, the authority to incur or pay obligations and access to financial and other information essential to the operation of the debtor.[105]

Applying that definition to the level of authority and discretion afforded to the debtor's general manager, the court held the general manager was not a "managing agent."[106]

In *In re City of Columbia Falls*, the bankruptcy court determined whether the City of Columbia Falls was a "managing agent" for certain debtors, which were "special improvement districts."[107] The city adopted a resolution creating the districts for the purpose of constructing sewer and water lines, paving streets and installing curbs, and constructing underground utilities for certain tracts of real property.[108]

The city had the power to create the districts, to extend the time for payment of assessments levied upon properties within the districts, to permit the payment of assessments in installments, and to pay all expenses incurred in making improvements.[109] The city, rather than the debtors, sold bonds to pay the costs of

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[100] 124 B.R. 318, 318–23 (Bankr. C.D. Cal. 1991).
[101] *Id*. at 324.
[102] *Id*.
[103] *Id*.
[104] *Id*.
[105] *In re Standard Stores, Inc.*, 124 B.R. at 323.
[106] *Id*. at 324.
[107] 143 B.R. 750, 752 (Bankr. D. Mont. 1992).
[108] *Id*. at 752–53.
[109] *Id*.

the improvements.[110] The city had the authority to control the creation and administration of the debtors.[111]

The city had operational control of the debtors, including authority to incur and pay obligations, and access to financial and other information essential to the debtors' operation.[112] The court held that the city was a "managing agent" of the districts.[113]

Whether applying the common law definition of "managing agent," the definition of that term as utilized in case law under the former Bankruptcy Act (repealed 1978), or the definition adopted in *Standard Stores*, a management company providing only consulting services is not a "managing agent." Where the management company does not have the power to direct corporate officers, to dictate corporate policy, to incur and pay obligations, to hire and fire personnel, and where the management company merely provides consulting services to the debtor in possession's management, the management company is not a "managing agent" within the meaning of section 101(31)(E).

E. "Sufficiently Close Relationship" under section 101(31)

Although a management company may not be an "insider" under the categories listed in section 101(31), those categories are not exhaustive.[114] An "insider" also includes any entity that has a "sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms length with the debtor."[115]

Pursuant to this open-ended definition of "insider," a court can cast a wide net and include many relationships within those "sufficiently close" to render an entity an "insider" with respect to a debtor in possession. A management company that does not control the decisionmaking of a debtor in possession's officers or dictate corporate policy should not be viewed as having a "sufficiently close relationship" with debtors in possession to constitute "insiders."[116] To hold otherwise may

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[110] *Id.* at 752–754.

[111] *Id.* at 765.

[112] *In re City of Columbia Falls*, 143 B.R. at 765.

[113] *Id.* at 764. *See In re* Bel Air Assocs., Ltd., 4 B.R. 168, 174 (Bankr. W.D. Okla. 1980) (holding property manager engaged as "exclusive renting, operating and managing agent" was "managing agent"). In several other decisions under the Bankruptcy Code, the courts conclude that a person is a "managing agent" with little or no analysis of the person's ability to exercise discretion or control of the debtor in possession. *See In re* Interwest Bus. Equip., Inc., 23 F.3d 311, 320 n.12 (10th Cir. 1994) (holding without much analysis that party was managing agent); *In re* Herby's Foods, Inc., 2 F.3d 128, 129 (5th Cir. 1993) (deciding parties were involved in management and thus insiders, without analyzing degree of control or discretion exercised by them); *In re* National Real Estate L.P. II, 87 B.R. 986, 991 (Bankr. E.D. Wis. 1988) (holding debtor's managing agent as insider without ample analysis of its role in debtor's affairs).

[114] *See* 11 U.S.C. § 102(3) (2000) (stating terms "includes" and "including" are "not limiting"); *In re* Krehl, 86 F.3d 737, 741 (7th Cir. 1996) (noting definition of insider in 101(31) was not intended to be exhaustive); *In re* Armstrong, 231 B.R. 746, 749 (Bankr. E.D. Ark. 1999) ("[T]he bank's assertion that the trustee must prove that the bank falls within one of the defined paragraphs of section 101(31) is incorrect because the statute begins with the non-exclusive term 'includes.'"); *In re* Sullivan Haas Coyle, Inc., 208 B.R. 239, 242 (Bankr. N.D. Ga. 1997) ("While section 101(31) lists specific relationships as insider relationships, the list is not exhaustive.").

[115] *See* S. REP. NO. 95-989, at 25 (1978); H.R. REP. NO. 95-595, at 312 (1977); *In re City of Columbia Falls*, 143 B.R. at 766 (quoting legislative history).

[116] *See* Friedman v. Sheila Plotsky Brokers, Inc. (*In re* Friedman), 126 B.R. 63, 70 (B.A.P. 9th Cir. 1991) ("[N]ot every creditor-debtor relationship attended by a degree of personal interaction between the parties rises to the level

decrease the likelihood that a troubled debtor in possession could successfully reorganize.[117]

Even where the engagement is structured so that individual consultants are engaged pre-petition as officers or directors and the management company is employed as a consultant and is otherwise "disinterested," one could argue that the insider status of the individual consultants should be imputed to disqualify the management company. Specifically, one could argue that the individual consultants status as officers or directors and therefore, "insiders" should be imputed to their management company to disqualify it from post-petition employment under section 327. For the reasons set forth below, however, that argument should fail.

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of an insider relationship."); *In re Sullivan Haas Coyle, Inc*., 208 B.R. at 246 (asserting management company was not "insider" for preference purposes because providing financial advice to debtor, and having knowledge of debtor's business, did not make entity "insider" absent control of debtor); *In re* Practical Inv. Corp., 95 B.R. 935, 941 (Bankr. E.D. Va. 1989) (finding creditor merely having financial power over debtor, but not being officer, director, or shareholder with control over debtor was insufficient to label creditor insider).

[117] The Bankruptcy Code utilizes the term insider in many sections. *See* 11 U.S.C. §§ 101(14), 101(31), 303(b)(2), 502(b)(4), 522(d)(10)(E)(i), 547(b)(4)(B), 550(c)(2), 702(a)(3), 747(1), 1104(c)(2), 1129(a)(5)(B), 1129(a)(10), (2000); *In re Sullivan Haas Coyle, Inc.*, 208 B.R. at 247 n.12 (noting Code sections which utilize term "insider"). A term utilized in several sections of the Bankruptcy Code is usually interpreted consistently in those sections. *See* Patterson v. Shumate, 504 U.S. 753, 758 n.2 (1992) ("[A] word is presumed to have the same meaning in all subsections of the same statute") (quoting Morrison-Knudson Constr. Co. v. Director, Office of Workers' Comp. Programs, U.S. Dept. of Labor, Et al., 461 U.S. 624, 633 (1983)); United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 371 (1988) ("[A] provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme -- because the same terminology is used elsewhere in a context that makes its meaning clear."); St. Laurent v. Ambrose (*In re* St. Laurent), 991 F.2d 672, 680 (11th Cir. 1993) ("[I]t is a basic canon of statutory construction that identical terms within an Act bear the same meaning."). *But see* Dewsnup v. Timm, 502 U.S. 410, 415–16 (1992) (favoring respondent's argument that term "allowed secured claim" had different meaning in section 506(a) and section 506(d) due to practice under former Bankruptcy Act (repealed 1978)). One can argue that the specific categories of "insider" relationships set forth in section 101(31) must be interpreted consistently in each section of the Bankruptcy Code utilizing the term "insider." One can also argue that the test of whether a professional person has a "sufficiently close relationship" to constitute an "insider" may differ depending upon the purpose of the Bankruptcy Code section utilizing the term "insider." For example, a professional person may have a sufficiently close relationship to constitute an "insider" for purposes of voting on a plan under section 1129(a)(10), while that professional person's relationship is not sufficiently close to preclude the professional person's employment under section 327(a). *Cf. In re* Oliver, 142 B.R. 486, 489 (Bankr. M.D. Fla. 1992)

> [I]t is obvious . . . that it is important to determine the purpose for which the term "insider" is used, and one must consider the underlying policy reasons for precluding an insider from participating in the administration of the estate as distinguished from permitting a preference action to be maintained against an insider by utilizing the one-year reachback provision of section 547 which involves totally different policy considerations. *Id.;*

In re Standard Stores, Inc., 124 B.R. 318, 324 (Bankr. C.D. Ca. 1991) ("In light of the many and varied uses of 'insider'. . . it is appropriate to consider the purpose of the particular statute in which the term 'insider' is used.").

VIII. IMPUTATION OF "INSIDER" STATUS TO MANAGEMENT COMPANIES EMPLOYED UNDER SECTION 327(A)

The imputation of conflicts or "insider" status to law firms has been the basis of significant disagreement in the courts when a debtor in possession seeks to employ a law firm that employs an "insider." Without significant analysis some courts have also extended this analysis to impute "insider" status to a management company employing an "insider."[118] There does not, however, appear to be any statutory basis for such imputation with respect to management companies.

When a debtor in possession employs an "attorney," the debtor in possession usually employs a law firm, rather than an individual attorney.[119] When a debtor in possession
employs a law firm, any member of the firm may act as counsel to the debtor in possession without further order of the court.[120]

In some instances, a member of the law firm may have served within two years prior to the petition date, or may presently serve, as an "officer" or "director" of the debtor in possession. That member is an "insider" and; therefore, not "disinterested," and may not be employed under section 327(a).[121]

Courts have struggled with the question of whether the member's status as an "insider" should be imputed to the law firm to disqualify the firm from employment under section 327(a). The Model Code of Professional Responsibility provides as follows:

> If a lawyer is required to decline employment or to withdraw from employment under a Disciplinary Rule, no partner or associate, or any other lawyer affiliated with him or his firm, may accept or continue such employment.[122]

The Model Rules of Professional Conduct similarly provide as follows:

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[118] Official Committee of Unsecured Creditors v. ABC Capital Mkts. Group and Capitol Metals Co., Inc. (*In re* Capitol Metals Co.), 228 B.R. 724, 727 (B.A.P. 9th Cir. 1998); *In re* United Color Press, Inc., 129 B.R. 143, 147 (Bankr. S.D. Ohio 1991).

[119] Section 101(4) defines an "attorney" as an "attorney, professional law association, corporation, or partnership, authorized under applicable law to practice law." 11 U.S.C. § 101(4) (2000). The same definition of "attorney" applies under the Federal Rules of Bankruptcy Procedure. *See* Fed. R. Bankr. P. 9001 ("[T]he definition of words and phrases in section 101 . . . and the rules of construction in section 102 of the Code govern their use in these rules."). In addition, the term "firm" is defined in Bankruptcy Rule 9001(6) as including a "partnership or professional corporation of attorneys or accountants." Fed. R. Bankr. P. 9001(6).

[120] Bankruptcy Rule 2014(b) provides that

> if under the Code and this rule, a law partnership or corporation is employed as an attorney, or an accounting partnership or corporation is employed as an accountant, or if a named attorney or accountant is employed, any partner, member, or regular associate of the partnership, corporation or individual may act as attorney or accountant so employed, without further order of this court. Fed. R. Bankr. P. 2014(b).

[121] *See* 11 U.S.C. § 101(14)(D) (2000) (stating person is not disinterested if she served "within two years before the date of the filing of the petition, [as] a director, officer, or employee of the debtor . . . ."); *see also* 11 U.S.C. § 101(14)(A) (2000) (stating "insider" is not "disinterested"); 11 U.S.C. § 101(31)(B)(i) (2000) (stating "director" is "insider"); 11 U.S.C. § 101(31)(B)(ii) (2000) (stating "officer" is "insider").

[122] MODEL CODE OF PROF'L RESP. DR 5-105(D) (2001)

> While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by Rules 1.7, 1.8(c), 1.9 [which involve conflicts of interest] or 2.2.[123]

The general rule under DR 5-105(D) and MR 1.10(a) is that the disqualification of a law firm member applies to disqualify all attorneys of such firm.[124] Based upon the DR 5-105(D) or MR 1.10(a), several courts have held that disqualification of a law firm member as an "insider" *per se* precludes the law firm from representing a debtor in possession.[125]

Other courts, however, have refused *per se* to disqualify an entire firm based upon the "insider" status of one firm member. These courts generally rely upon the softening of the interpretations of DR 5-105(D) and MR 1.10(a) and conclude the Bankruptcy Code does not require such *per se* disqualification.

For example, in *In re Timber Creek, Inc*., the bankruptcy court considered whether the disqualification of a law firm member should be imputed to the law firm.[126] The law firm member was a shareholder of the debtor's holding company, and a director for the debtor and its parent.[127] In practice, the member's involvement in such corporate capacities was very minimal.[128] The law firm member agreed to resign from his corporate positions and to refrain from attending any meetings of the debtor in possession or otherwise participating in the debtor in possession's affairs.[129]

The bankruptcy court noted that DR 5-105(D) has been tempered over time by the ethical screen concept.[130] The court added that a strict application of the DR 5-105(D) was inconsistent with the modern practice of law.[131] After considering the totality of the facts, including the adequacy of the firm's screening mechanisms and curative measures, the bankruptcy court concluded the law firm member's "insider" status did not preclude the law firm's employment under section 327(a).[132]

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[123] MODEL RULES OF PROF'L CONDUCT R. 1.10(a) (2001)

[124] *See* U.S. Trustee v. S.S. Retail Stores Corp. (*In re* S.S. Retail Stores Corp.) 211 B.R. 699, 702 (B.A.P. 9th Cir. 1997) (holding attorney's disqualification to represent client applies to every attorney in firm where disqualified attorney practices), *appeal dismissed*, 162 F.3d 1230 (9th Cir. 1998); *In re* Mortgage & Realty Trust, 195 B.R. 740, 754 (Bankr. C.D. Cal. 1996) (holding disqualification of single attorney extends vicariously to entire firm); *see also* Trone v. Smith, 621 F.2d 994, 999 (9th Cir. 1980) (stating substantial relationship between disqualified attorney and firm is itself sufficient to disqualify).

[125] *See In re* Envirodyne Indus., 150 B.R. 1008, 101–18 (Bankr. N.D. Ill. 1993) (stating if one attorney of firm is ineligible to represent debtor-in-possession firm is disqualified from representing client); *In re* Philadelphia Athletic Club, Inc., 20 B.R. 328, 338 (E.D. Pa. 1989) (concluding disqualified attorney by debtor-in-possession, who is member of firm, serves to disqualify all members of firm); *In re* Wells Benrus Corp., 48 B.R. 196, 198–99 (Bankr. D. Conn. 1985) (stating disqualification of any attorney causes every attorney in firm to be disqualified).

[126] *In re* Timber Creek, Inc., 187 B.R. 240, 241 (Bankr. W.D. Tenn. 1995), *aff'd*, Vergos v. Timber Creek, Inc., 200 B.R. 624, 628 (W.D. Tenn. 1996) (concluding there is no basis in Bankruptcy Code for imputing disqualification of individual to that person's associated ties).

[127] *Id*. at 241.

[128] *Id*.

[129] *Id*. at 244.

[130] *Id*.

[131] *In re* Timber Creek, Inc., 187 B.R. at 244.

[132] *Id*. at 244–45.

In *In re Capen Wholesale, Inc.*, the district court also considered whether a law firm member's status as an "insider" required the *per se* disqualification of the law firm.[133] The law firm member served as the debtor's assistant secretary for ten years, but had resigned from that position two weeks before the debtor filed its bankruptcy petition.[134] The member claimed he never took any action as assistant secretary.[135] The member stated that he would not participate in the debtor's bankruptcy proceeding.[136]

The court noted the conflicts of interest contemplated in MR 1.7, 1.8 and 1.9 were not implicated by the member's "insider" status.[137] Thus, the court concluded the MR did not require the court to impute the member's disqualification to his law firm.[138]

The court reasoned that nothing in the Bankruptcy Code or Bankruptcy Rules required the imputation of the member's disqualification to his law firm.[139] The court stated that Congress could have provided for such imputation of disqualification if it had so intended.[140] The court pointed out that imputation of disqualification was specifically provided in Bankruptcy Rule 5002(a) with respect to relatives of the bankruptcy judge.[141] "Whenever under this subdivision an individual may not be approved for appointment or employment, the individual's firm, partnership, corporation, or any other form of business association or relationship, and all members, associates and professional employees thereof also may not be approved for appointment or employment." Thus, the district court reversed the bankruptcy court's order denying approval of the law firm as counsel for the debtor in possession.[142]

Similarly, in *In re Keravision, Inc.*,[143] the district court held that the wording of section 327(a) and 101(14)(D)[144] of the Bankruptcy Code, do "not provide for vicarious disqualification."[145] The court concluded that a law firm was not disqualified from representing a debtor in possession "simply because one of its

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[133] 184 B.R. 547, 549 (N.D. Ill. 1995).
[134] *Id*. at 548.
[135] *Id*.
[136] *Id*. at 551.
[137] *Id*.
[138] *In re* Capen Wholesale, Inc., 184 B.R. at 551.
[139] *Id*.
[140] *Id*.
[141] *Id*. at 551; *see* Fed. R. Bankr. P. 5002(a) ("The employment of an individual as an attorney, accountant, appraiser, auctioneer or other professional person pursuant to sections 327, 1103, or 1114 shall not be approved by the court if the individual is a relative of the bankruptcy judge approving the employment.").
[142] *In re Capen Wholesale, Inc.*, 184 B.R. at 551; *see also* United States Trustee v. S.S. Retail Stores Corp. (*In re* S.S. Retail Stores Corp.), 211 B.R. 699, 703–04 (B.A.P. 9th Cir. 1997) (concluding there is no reason to apply per se rule to disqualify disinterested member of firm based upon firm's employment of disqualified member) *appeal dismissed*, 162 F.3d 1230 (9th Cir. 1998); *In re* Creative Restaurant Management Inc., 139 B.R. 902, 912–13 (Bankr. W.D. Mich. 1992) (refusing to impute law firm member's "insider" status to law firm for purposes of employment under section 327(a)).
[143] 273 B.R. 614 (N.D. Ca. 2002).
[144] Section 327(a) of the Bankruptcy Code requires a professional person to be "disinterested." See 11 U.S.C. § 327(a). Section 101(14)(D) of the Bankruptcy Code provides that a person is not "disinterested" if she served as an "officer" of the debtor within 2 years prior to the petition date. See 11 U.S.C. § 101(14)(D).
[145] *In re* Keravision, 273 B.R. at 616.

partners was an officer" of the debtor until three weeks before the debtor filed its bankruptcy petition.[146]

Whatever the propriety of imputing "insider" status to law firms under DR 5-105(D) and MR 1.10(a), there is no basis to impute to a management company the "insider" status of one of its members. Even if DR 5-105(D) or MR 1.10(a) were applicable to impute disqualification based upon "insider" status, rather than conflicts of interest, there is no similar rule applicable to the employment of management companies.

A few bankruptcy courts have imputed to a management company the "insider" status of its employees. In *In re United Color Press, Inc.*, the debtor in possession sought to employ a management consulting firm pursuant to section 327(a).[147] Prior to the petition date, one of the management company's individual consultants agreed to serve on the debtor's board of directors to insure that the debtor had an adequate number of directors to act on the resolution to file a bankruptcy petition.[148]

The United States Trustee objected to the debtor in possession's application to retain the management company under section 327(a).[149] The trustee argued that the management company was not disinterested because one of its financial advisors had served as a director of the debtor.[150] The court held that it was "constrained to find that because an employee of [management company] served as a director of [the debtor], [the management company] is statutorily not a 'disinterested' person and may not, therefore, be appointed a 'professional person' under Section 327(a)."[151] The court in *In re United Color Press, Inc.* did not provide any other support or legal basis for its imputation of the individual consultant's status as an "insider."

In *Official Committee of Unsecured Creditors v. ABC Capital Markets Group (In re Capitol Metals Co.)*, prior to filing its bankruptcy petition, the debtor entered into a memorandum of understanding pursuant to which the debtor retained (i) an individual consultant to serve as the debtor's chief financial officer and (ii) a financial advisor to assist the debtor with the sale of its business.[152] The entity serving as the financial advisor had only two employees, the individual serving as the chief financial officer and his wife.[153] One year later, the debtor entered into a consulting agreement with the financial advisor pursuant to which the financial advisor was hired to replace the individual consultant and to serve as the debtor's chief financial officer.[154] Thereafter, the debtor filed a chapter 11 bankruptcy

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[146] *Id*. at 616, 619.
[147] 129 B.R. 143 (Bankr. S.D. Ohio 1991).
[148] *Id*. at 144.
[149] *Id*. at 146.
[150] *Id*.; *see also* 11 U.S.C. § 101(14)(A) (2000) (stating "'disinterested person' means person that is not . . . an insider"); 11 U.S.C. § 101(31)(B)(i) (2000) (stating "'insider' includes . . . director of the debtor"); 11 U.S.C. § 327(a) (2000) (stating "the trustee . . . may employ one or more . . . professional persons . . . that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.").
[151] *In re United Color Press, Inc.*, 129 B.R. at 147.
[152] 228 B.R. 724 (B.A.P. 9th Cir. 1998).
[153] *Id*. at 725.
[154] *Id*.

proceeding.[155] The debtor in possession sought to employ the financial advisor as a consultant pursuant to section 327(a).[156]

The bankruptcy court held that the financial advisor was not disinterested as required by section 327(a).[157] The court reasoned that the financial advisor was not disinterested because it was engaged as the debtor's officer prior to the petition date.[158]

The court acknowledged that the *In re S.S. Retail Stores Corp.* case supported the proposition that a firm is not *per se* disqualified from representing a debtor in possession solely because a member of the firm was an officer of the debtor.[159] The court, however, distinguished *In re S.S. Retail Stores Corp.*, and declared that the disinterestedness standard "would be eradicated by corporate form over substance" when the only person working with the debtor is the person who is not disinterested.[160]

In *In re Capitol Metals Co.*, the financial advisor was clearly not disinterested because it had served as the debtor's officer. The court, however, in its discussion of *In re S.S. Retail Stores Corp.* also appeared to impute the individual consultant's status as officer to the financial advisor. Absent a statutory or rule basis providing for the imputation of "insider" status, a better approach may have been to hold that the financial advisor was ineligible for employment because it had a "sufficiently close relationship" with the debtor in possession and; therefore, was not disinterested.

The financial advisor's second employee was the wife of the debtor's officer and first employee. The wife was not disinterested as a "relative" of an officer of the debtor.[161] As both of the employees of the proposed financial advisor were "insiders," the financial advisor may have had a "sufficiently close" relationship with the debtor in possession to render the financial advisor ineligible for employment.

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[155] *Id*.

[156] *Id*.

[157] *In re Capitol Metals Co.*, 228 B.R. at 726–27; *see also* Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir. 1994) (stating that purpose of section 327(a) is to "serve the important policy of ensuring that all professionals appointed pursuant to section 327(a) tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities"); Childress v. Middleton Arms, L.P., (*In re* Middleton Arms), 934 F.2d 723, 725 (6th Cir. 1991) ("327(a) clearly states…that the court cannot approve the employment of a person who is not disinterested . . . .").

[158] *In re Capitol Metals Co.*, 228 B.R. at 727; *see* 11 U.S.C. § 101(14)(D) (2000) (defining "disinterested person" as person that "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 of an investment banker [for the debtor] . . . ."); s*ee also* Michel v. Eagle-Picher Indus., Inc. *(In re* Eagle-Picher Indus.), 999 F.2d 969, 972 (6th Cir. 1993) (holding investment banking firm, Goldman Sachs, had pre-petition relationship as investment banker for outstanding securities of debtors and; therefore, was not disinterested).

[159] *In re Capitol Metals Co.*, 228 B.R. at 727; *see also In re* Martin, 817 F.2d 175, 182 (1st Cir. 1987) (discussing need for case-by-case analysis rather than per se disqualification of firm if lawyer's interest was adverse to client); *In re* Creative Rest. Mgmt., Inc., 139 B.R. 902, 913 (Bankr. W.D. Mo. 1992) ("The Bankruptcy Code contains no requirement that an entire law firm is *per se* ineligible for employment due to one of its members having previously served as an officer of the debtor.").

[160] *In re Capitol Metals Co.,* 228 B.R. at 727.

[161] *See* 11 U.S.C. § 101(31)(B)(vi) (2000) (stating "relative of . . . officer" is "insider"); 11 U.S.C. § 101(45) (2000) (defining "relative");*see also In re* Career Concepts, Inc., 76 B.R. 830, 833 (Bankr. D. Utah 1983) (stating father and brother of officer were not disinterested persons and were ineligible for employment as attorneys for debtor in possession).

The fact that an employee of a management company served or is serving as an officer or director of a debtor or debtor in possession should not lightly be imputed to the management company to disqualify the firm. The "insider" status of an individual consultant of a management company should not be imputed to the management company where the officer or director is engaged directly by the debtor in possession, exercises his or her judgment without being controlled by the management company, and is compensated directly by the debtor in possession with respect to its services as an officer or director, and provided that the management company has other non-insider employees that will provide the management consulting services.

IX. SECTION 1107 DOES NOT AUTHORIZE EMPLOYMENT OF NON-DISINTERESTED PROFESSIONAL PERSONS UNDER SECTION 327(A)

Where a professional person is not "disinterested" as required by section 327(a), section 1107(b) of the Bankruptcy Code does not provide a mechanism to employ non-disinterested professionals. Section 1107(b) provides that "[n]otwithstanding section 327(a) of this title, a person is not disqualified for employment under section 327 of this title by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case."[162] One could argue that section 1107(b) remedies a management companies failure to be disinterested as a result of its pre-petition employment as an officer or director of a debtor. Broadly interpreting section 1107(b) in that manner, however, would conflict with the "disinterestedness" requirement of sections 327(a) and 101(14).[163]

As the Supreme Court has instructed, "[s]tatutory construction . . . is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme . . . because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law."[164] Section 1107(b) should not be interpreted as overriding section 327(a). Rather, section 1107(b) should be interpreted in a manner that is compatible with the disinterestedness requirement of section 327(a). Specifically, section 1107(b) should be interpreted as providing that a professional person is eligible for post-petition employment even though the professional person was employed pre-petition by the debtor, provided that the professional person is disinterested. For

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[162] 11 U.S.C. § 1107(b) (2000); *see also In re* Immenhausen Corp., 159 B.R. 45, 47 (Bankr. M.D. Fla. 1993) ("[O]n-going relationship between the debtor and the attorney does not preclude appointment."); *In re Creative Rest. Mgmt., Inc.*, 139 B.R. at 915 ("The fact that a law firm previously represented a company does not make such firm ineligible to represent that company, as debtor-in-possession.").

[163] *See* Michel v. Federated Dept. Stores, Inc. (*In re* Federated Dept. Stores, Inc.), 44 F.3d 1310, 1318–19 (2d Cir. 1995) ("Where a professional is disqualified for other reasons expressly listed in the statutory definition of an 'interested person,' section 1107(b) does not apply . . . . [T]o read section 1107(b) as providing an exception in this case would be to rob section 101(14)(B) and (C) of any meaning in cases with debtors- in-possession."); Childress v. Middleton Arms, L.P. (*In re* Middleton Arms, L.P.), 934 F.2d 723, 725 (6th Cir. 1991) ("[T]he section 1107(b) exception does not apply to all interested persons, but only to those who fail to be disinterested solely because of prior employment").

[164] United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 371 (1988); *see also* Weinberger v. Hynson, Westcott & Dunning, Inc., 412 U.S. 609, 631–32 (1973) (stating court's task is to interpret so as to give "'the most harmonious comprehensive meaning possible' in light of legislative policy and purpose.").

example, where the debtor employed the management company as a consultant pre-petition, rather than as an officer or director, section 1107(b) provides that the pre-petition engagement, by itself, does not render the management company to be interested and ineligible for post-petition employment.[165] If, however, the management company is not disinterested for some reason, such as its status as an officer or director, section 1107(b) does not render the management company eligible for employment.[166] Thus, section 1107(b) cannot remedy a debtor's careless structuring of its engagement of a management company as an "officer" or "director."

X. ENGAGEMENT OF TURNAROUND MANAGERS AND DELAWARE GENERAL CORPORATION LAW

In addition to creating disinterestedness issues, structuring the retention of a management company in the manner chosen in *Bartley* and *Capitol* may also violate state corporation law. Such law may require a natural person to serve as an officer or director.[167]

A debtor's or debtor in possession's board may also run afoul of the Delaware General Corporation Law ("DGCL") if the board retains a management company under the structure chosen in *Bartley* and *Capitol*. Authorizing a management company to designate its individual consultants as officers of the debtor or debtor

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[165] *See In re Federated Dept. Stores, Inc*., 44 F.3d at 1318 (providing section 1107(b) applied where professional would otherwise be disqualified "solely" because of pre-petition employment); Michel v. Eagle-Picher Indus., Inc. (*In re* Eagle-Picher Indus., Inc.), 999 F.2d 969, 972 (6th Cir. 1993) (same); *In re Middleton Arms, L.P*., 934 F.2d at 725 (holding real estate agency was interested party ineligible for employment under section 327(a) because of insider status, not pre-petition employment); *In re* Leisure Dynamics, 32 B.R. 753, 755 (Bankr. D. Minn.) (disqualifying legal counsel for post-petition employment under section 327(a) because of insider status, not prior employment), *aff'd*, 33 B.R. 121 (D. Minn. 1983).

[166] *See* United States Tr. v. Price Waterhouse, 19 F.3d 138, 141 (3d Cir. 1994) (interpreting 11 U.S.C. § 1107(b) to create no exception for pre-petition creditor); *In re Eagle-Picher Indus., Inc*., 999 F.2d at 972 (investment banker was not disinterested person and section 1107(b) was inapplicable); *In re Middleton Arms, L.P.*, 934 F.2d at 725 (noting insider status makes real estate agency interested party and section 1107(b) was inapplicable); *In re* Yuba Westgold, Inc., 157 B.R. 869, 872 (Bankr. N.D. Iowa 1993) (explaining professional service firm possibly considered "in control of debtor" and; therefore, not disinterested person). *But see In re* Madison Mgmt. Group, Inc., 137 B.R. 275, 284 (Bankr. N.D. Ill. 1992) (interpreting 11 U.S.C. § 1107(b) to allow debtor to retain financial advisor and workout specialist regardless of disinterestedness).

[167] *See* NFL Prop. Inc. v. Superior Ct., 75 Cal. Rptr. 2d 893, 899 n.5 (Ct. App. 1998) ("Director of a corporation must be a natural person, pursuant to [California] Corporations Code section 164."); Rohe v. Reliance Network Training, Inc., No. 17992, 2000 WL 1038190, at *9 n.22 (Del. Ch. July 21, 2000) (noting that Texas Business Corporation Act requires that "natural persons" serve as directors or officers); Stuart D. Ames & Kathleen L. Deutsch, *The Formation of Corporations*, THE FLORIDA BAR, FLORIDA CORPORATE PRACTICE, chap. 2 (1999) ("A director must be a natural person . . . ."); KAREN CUSENBARY, ET AL., 12 OHIO JUR. 3D § 339 (1995) ("Corporate directors must be natural persons; a corporation cannot be a director or officer of another corporation."); SUSAN KALINKA, 9 LA. CIV. L. TREATISE § 1.24 (3d ed. 1998) ("[A] corporation must have at least three directors who are natural persons . . . ."). *But see In re* Keravision, 273 B.R. 614, 616 (N.D. Cal. 2002) (stating that without analysis trustee's argument "erroneously assumes that a law firm or other entity cannot be an officer of a corporation."). A corporation may, however, serve as a manager of a limited liability company in some states. *Compare* John M. Cunningham, *The Limited Liability Company: Entity of Choice for High-Tech Start-Ups?*, 13 COMPUTER LAW 11, 16 (April 1996) ("[C]orporate directors must be natural persons, and they are personally liable for breaches of director duty. LLC managers may be entities. . . .") *with* Robert R. Keating, et al., *The Limited Liability Company: A Study of The Emerging Entity*, 47 BUS. LAW. 375, 428 (1992) ("Colorado LLCs must appoint a manager who is a natural person at least 18 years of age.").

in possession may constitute an abdication of the board's duty to select officers of the debtor.

Section 142(a) of the DGCL provides that "[o]fficers shall be chosen in such manner" as prescribed "by the bylaws or determined by the board of directors."[168] In addition, section 142(e) of the DGCL provides that "[a]ny vacancy occurring in any office of the corporation by death, resignation, removal or otherwise shall be filled as the bylaws provide. In the absence of such a provision, the vacancy shall be filled by the board of directors."[169]

Pursuant to section 141(a) of the DGCL, the "business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors."[170] The "customary duties and obligations of the board" include deciding "which officers will run" the corporation's business operations.[171] Although a board may delegate much of its responsibility, it must satisfy its obligations by, *inter alia*, "thoughtfully appointing officers."[172]

A director breaches the fiduciary duty of care by abdicating managerial duties.[173] A board "may not formally or effectively abdicate its statutory power and its fiduciary duty to manage or direct the management of the business and affairs of [the] corporation. The term 'management,' as used in this context, relates to 'supervision, direction and control.'"[174] Although the case law varies on what constitutes an excessive delegation, the case law is consistent in holding that a board may not delegate a specific statutory duty.[175] Thus, a board of a debtor in

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[168] DEL. CODE ANN. tit. 8, § 142(a) (1975).

[169] DEL. CODE ANN. tit. 8, § 142(e) (1975).

[170] DEL. CODE ANN. tit. 8, § 142(a).

[171] R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, 1 THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.1, at 4-5 (3d ed. 2001); *see* DEL. CODE ANN. tit. 8, § 142(b) (1975) (providing board of directors with power to choose officers); 18B AM. JUR. 2D *Corporations* § 1360 (1985) (noting that appointment of officers of corporation is task usually entrusted to board of directors).

[172] BALOTTI & FINKELSTEIN, *supra* note 168, § 4.17, at 4-33 (quoting Grimes v. Donald, No. CIV. A No. 13358, 1995 WL 54441, at *8 (Del. Ch. Jan. 11, 1995), *aff'd*, 673 A. 2d 1207 (Del. Supr. 1996)); *see also* Grimes v. Donald, 673 A.2d 1207, 1214–15 (Del. Sup. 1996) (discussing board of directors powers of delegation and limits thereon); ERNEST L. FOLK, ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 142.4 (3d ed. 1998) (comparing traditional officer selection via board to stockholder election of officer's in minority of corporations).

[173] *See* Canal Capital Corp. v. French, Civ. A. No. 11,764, 1992 WL 159008, at *6 (Del. Ch. July 2, 1992) (holding corporate board did not abdicate managerial responsibilities by delegating to management company because board retained control at all times); Chapin v. Benwood Found., Inc., 402 A.2d 1205, 1210–11 (Del. Ch. 1979) ("[D]irectors of a Delaware corporation may not delegate to others those duties which lay at the heart of the management of the corporation."); Lehrman v. Cohen, 222 A.2d 800, 808 (Del. Ch. 1966) ("It is settled, of course, as a general principle, that directors may not delegate their duty to manage the corporate enterprise."); BALOTTI & FINKELSTEIN, *supra* note 168, § 4.17 at 4-34 (noting director breaches his fiduciary duty of care by abdicating his managerial duties).

[174] Grimes v. Donald, No. CIV. A. 13358, 1995 WL 54441, at *9 (Del. Ch. Jan. 11, 1995) (stating that board's right to delegation is limited by principle that "board may not either formally or effectively abdicate its statutory power and its fiduciary duty to manage or direct the management of the business and affairs of this corporation"), *aff'd*, 673 A.2d 1207 (Del. 2001); Field v. Carlisle Corp., 68 A.2d 817, 820 (Del. Ch. 1949) ("[U]nder the Delaware statutes the directors of a Delaware corporation may not delegate, except in such manner as may be explicitly provided by statute, the duty to determine the value of the property acquired as consideration for the issuance of stock"); *see also* Adams v. Clearance Corp., 121 A.2d 302 (Del. 1956) (noting "general principle of non-delegation of directors' duties").

[175] *See* Jackson v. Turnbull, Civ. A. No. 13042, 1994 WL 174668, at *5 (Del. Ch. Feb. 8, 1994) (finding board of directors impermissible delegated statutory duty to determine the appropriate consideration in a merger transaction), *aff'd*, 653 A.2d 306 (Del. Sup. 1994); *Field*, 68 A.2d at 820 (Del. Ch. 1949) (concluding that directors of corporation may not delegate statutory duty); BALOTTI & FINKELSTEIN, *supra* note 168, § 4.17, at 4-34 (noting that corporate directors may not delegate statutory duties).

possession may violate section 142(a) and (e) and abdicate its managerial responsibility by permitting a management company to select the debtor in possession's officers, particularly where the board lacks authority to reject any candidate.

Notwithstanding the creation of "disinterestedness" issues and potential violations of the DGCL, many management companies are engaged under a structure similar to that involved in *Bartley* and *Capitol* where the management company is retained as an officer or director and agrees to provide individuals to serve in such capacities. There are many benefits to that structure. It allows continuity. The management company may simply designate other individuals to serve as officers or directors upon the termination of any existing officer's or director's employment with the management company. In addition, the *Bartley* and *Capitol* structure allows the management company to receive the compensation, rather than the individual consultants. That structure, however, may render the management ineligible for post-petition employment by a debtor in possession. That structure may also violate the DGCL and constitute an abdication of the board's duty to appoint the debtor in possession's officers.

The retention of a management company should be structured in a manner consistent with the requirements of "disinterestedness" and the DGCL (or other applicable state law). The management company should not be retained as an officer or director. Rather, the management company should be retained by the debtor's board as a consultant under section 327(a). The individual consultants should be directly employed by the debtor as officers or directors under section 327(b). The officers must be able to act independently of the management company and with the autonomy to make corporate decisions. The management company should not be authorized to provide individuals to serve as officers of the debtor, especially without board oversight. Otherwise, the management company could become ineligible to be engaged under section 327(a) because it is "in control" of the debtor in possession and, therefore, not disinterested.[176]

XI. JAY ALIX PROTOCOL

The issues concerning (i) the proper structure for the engagement of turnaround management companies and (ii) the scope of their indemnification was the subject of recent settlement agreements between the United States Trustee for Region 3 and Jay Alix & Associates and its affiliates (collectively, "Jay Alix") in the bankruptcy cases of *In re Safety-Kleen Corp.* and *In re Harnischfeger Industries, Inc.*, both pending before the Honorable Peter J. Walsh of the United States Bankruptcy Court for the District of Delaware.[177] The United States Trustee

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[176] *See* 11 U.S.C. §§ 101(14)(A), 101(31)(B)(iii) (2000) (defining "disinterested person" as one who is not an "insider," which includes person "in control of debtor"); Official Comm. of Unsecured Creditors v. ABC Capital Mkts. Group and Capitol Metals Co., Inc. (*In re* Capitol Metals, Co.), 228 B.R. 724, 726–27 (B.A.P. 9th Cir. 1998) (deeming chief financial officer not "disinterested" and disqualifying him to act as professional for debtor's estate); *In re* Weaver Potato Chip Co., Inc., 243 B.R. 737, 740 (Bankr. D. Neb. 2000) ("An insider includes a director, officer, or person in control of the debtor . . . .").

[177] *In re* Safety-Kleen Corp., Ch. 11 Case No. 00-02303 (PJW), Adv. Proc. No. 00-1984, 2001 Bankr. LEXIS 1296 (Bankr. D. Del. Aug. 27, 2001); *In re* Harnischfeger Indus., Inc., Bankr. No. 99-02171 (Bankr. D. Del. 2001).

opposed the engagement of Jay Alix, sought to disqualify Jay Alix and to obtain disgorgement and prospective disallowance of fees and expenses based upon Jay Alix's alleged failure to satisfy the disinterested requirement of section 327 and 101(14) of the Bankruptcy Code and objected to the proposed terms of an indemnity provision in favor of Jay Alix.[178]

Jay Alix had been seeking employment in a number of cases in which Jay Alix's principals served as officers or directors of the debtor. The engagements were typically structured with Jay Alix as the entity employed by the debtors, receiving compensation for providing services as officers or directors, and receiving indemnity agreements in favor of, *inter alia*, Jay Alix and its principals.

The settlements in *In re Safety-Kleen Corp.* and *In re Harnischfeger Industries, Inc.* both contained a protocol setting forth the future terms of Jay Alix's engagement in bankruptcy cases (the "Jay Alix Protocol").[179] The protocol, identical in each case, provided in relevant part as follows:

> a) Jay Alix will not act in more than one of the following capacities in any bankruptcy cases of a debtor and its affiliates: (i) crisis manager, (ii) financial advisor, (iii) claims administrator, or (iv) investor/acquirer. Jay Alix may not switch to another capacity once it has been retained.[180]
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> b) Engagements involving the furnishing of interim executive officers ("crisis management services") shall be provided through JA&A Services LLC ("JAS").[181]
>
> c) JAS shall seek retention under section 363 of the Bankruptcy Code with respect to its crisis management services. In all other cases, Jay Alix shall seek retention under section 327 of the Bankruptcy Code.[182]
>
> d) Individuals providing crisis management services as executive officers shall be retained in such position upon the express approval of an independent board of directors whose members are performing their duties and obligations as required under applicable law. Such individuals will act under the direction, control and supervision of the board and will serve at the board's pleasure.[183]
>
> e) Jay Alix shall not seek to be retained in any bankruptcy case in which a principal, employee or independent contractor of Jay Alix

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[178] *See* Objection of the United States Trustee to Debtors' Application for Authority to Retain and Employ Jay Alix and Associates as Restructuring Consultants, *In re Safety-Kleen Corp.,* Case No. 00-02303; Motion of the United States Trustee to (1) Disqualify Jay Alix & Associates, (2) To Disgorge Compensation and Reimbursement Paid to Jay Alix & Associates and (3) To Prospectively Deny Compensation and Reimbursement Due Jay Alix & Associates, *In re Harnischfeger Indus., Inc*., Bankr. No. 99-02171.

[179] In *In re Safety-Kleen Corp.*, the Jay Alix Protocol is attached to the settlement agreement, Docket No. 2825, which was filed on September 11, 2001. The Order approving the Settlement, including the Jay Alix Protocol, was docketed on October 4, 2001, as Docket No. 2920. In *In re Harnischfeger Industries, Inc.*, the Jay Alix Protocol is attached to the settlement agreement, Docket No. 11741, which was filed on October 3, 2001. The Order approving the settlement agreement, including the Jay Alix Protocol, was docketed on October 4, 2001, as Docket No. 11744.

[180] *Jay Alix Protocol* at paras. I.A, IV.A.

[181] *Id*. at para. I.B.

[182] *Id*. at paras. I.C , G.

[183] *Id*. at para. I.D.

> is, or has within two (2) years prior to the filing of the bankruptcy petition, served as a director of the debtor.[184]
> f) Compensation for crisis management services shall be paid to JAS.[185]
> g) The individuals providing crisis management services as executive officers shall be entitled to indemnification 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. There shall be no other indemnification of Jay Alix.[186]

As indicated above, the Jay Alix Protocol represents a negotiated settlement. As such, it does not represent a perfect application of the law to the facts.

The Jay Alix Protocol confuses the issue of who or what is actually being retained to provide crisis management services. The Jay Alix Protocol provides that (a) JAS shall furnish individuals to serve as executive officers and (b) the individuals will be retained and serve under the direction, control and supervision of the debtor's board of directors, and at the board's pleasure.[187] The Jay Alix Protocol, however, provides that the compensation for such services shall be paid to JAS.[188] By providing that JAS shall furnish interim executive officers and receive the compensation for their services, the Jay Alix Protocol confuses the issue of whether the debtor in possession is engaging the individual consultants or JAS to serve as executive officers.

In addition, the Jay Alix Protocol provides that JAS shall be retained to provide such crisis management services under section 363 of the Bankruptcy Code.[189] As discussed, *supra*, a crisis or turnaround manager is a "professional" for purposes of section 327(a).[190] Even if the engagement of a crisis manager were to satisfy the two-pronged test for an "ordinary course" professional under section 363, the more specific provision of section 327(a) should govern the employment. Moreover, if the individuals were actually being retained as the executive officers, on salary, they could be employed without court approval under section 327(b).

With respect to the indemnification of the individuals serving as executive officers, the Jay Alix Protocol correctly limits the scope of their indemnification to the indemnification provided to other corporate officers.[191] There is no basis to exceed the scope of indemnification under applicable state corporation law.[192]

CONCLUSION

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[184] *Id*. at 2 n.3.
[185] *Jay Alix Protocol* at para II.A.
[186] *Id*. at paras. III.A and B.
[187] *Id*. at paras. I, B and D.
[188] *Id*. at para. II.A.
[189] *Id*. at paras. I.C.
[190] *See supra* section VI of this article.
[191] *Jay Alix Protocol*, at paras. III.A and B.
[192] The subject of indemnifying and exculpating officers and agents in bankruptcy cases is the topic of another article in this publication.

A management company typically falls within the purview of "professional persons" under section 327(a). Accordingly, a prospective debtor in possession must be careful to insure that it deals with the management company in a manner that will not render the management company not "disinterested" and, therefore, ineligible for employment under section 327(a). For example, by failing to pay the management company in advance, a debtor in possession may expose the management company to potential preference liability thereby rendering it ineligible for employment due to adversity to the estate's creditors. In addition, the manner in which a debtor in possession structures the engagement of a management company and its individual consultants can determine whether the management company is "disinterested" and eligible for employment under section 327(a). A debtor in possession must be careful to separate the retention of any individual consultants as directors or salaried "officers" under section 327(b) from the retention of the consultants' management firm under section 327(a). By collapsing those engagements, a debtor in possession may render the management firm ineligible for employment under section 327(a), forcing the debtor in possession to retain a new turnaround management company at the initial, critical stage in the bankruptcy case.

In addition, the debtor in possession's board of directors may breach its fiduciary duty by abdicating its duty to mange the company and appoint officers where the board authorizes a management company to appoint officers, particularly where the board of directors retains no oversight with respect to such appointments. Therefore, a debtor in possession must be careful in structuring the engagement of its turnaround managers to insure their continued availability to assist the debtor in its bankruptcy case.