Testimony before the American Bankruptcy Institute Commission to Study the Reform of Chapter 11

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My name is William Snyder, and I am a Principal with Deloitte Financial Advisory Services LLP and the national service line co-leader for its Corporate Restructuring Group, Deloitte CRG. Deloitte CRG is an internationally recognized leader in corporate restructuring and globally has over 1,400 restructuring professionals. I have been in management positions for over 30 years, have over 20 years of restructuring experience, and have held court appointed positions in over 30 companies, including Pilgrim's Pride Corporation and the Texas Rangers baseball team. In over half of these cases I served as an interim C-suite level officer which was the standard before the term Chief Restructuring Officer (CRO) was used widely. Additionally, I have also twice served as an Examiner, including Mirant Energy, and have served as a Chapter 11 Trustee once. I am a Certified Turnaround Professional and have spoken on many panels in industry conferences. This statement reflects my own views and in no way reflects the views of Deloitte Financial Advisory Services LLP.

The Need for a Chief Restructuring Officer

Chapter 11 of the Bankruptcy Code creates the distinctive concept of the "debtor in possession," which is defined in § 1101[1] to mean the debtor in a chapter 11 case, except where a trustee has been appointed in the case. The debtor, as debtor in possession, is vested with the

[1] Section (§) references herein are to the United States Bankruptcy Code.

rights, powers, and duties of a trustee, and the ability to operate the debtor's business during the course of the case. In a corporate chapter 11 reorganization or liquidation process, therefore, existing management presumptively remains in control of the debtor's business.

The debtor in possession model serves the process well. The board of directors of a company and existing management are in most cases best-suited to engineer operational restructuring plans. They typically possess far more "institutional knowledge" of a company's history and operations, and are much more invested in its success, than any hired outside advisor. Indeed, it is nearly impossible for an outsider to step into a company and fully appreciate every nuance of that company within the time constraints necessary to turn the company around in a crisis. Existing, competent management is therefore a critical piece of any turnaround. Boards of Directors who understand their duties and exercise them prudently can—aided by competent management—guide a firm through turbulent times with the proper professional assistance. In their absence, a "lights out" scenario in most instances yields a very low outcome for creditors.

Financial crisis, however, adds a new aspect to the company's business operation—one that frequently exceeds the experience of existing management. When a company finds itself in the position of having to undergo a substantial restructuring—whether financial or operational—it must often turn to outside experts to provide unvarnished, unbiased advice and guide it through the crisis. How this plays out in practice depends both on the competency of existing management and the severity of the crisis. In my own experience, I have generally seen this scenario unfold in one of three ways.

The first involves companies whose management is both sufficiently competent and trustworthy to operate the business and, in addition, to navigate the restructuring process. Such cases are uncommon, as it is the rare company whose management possesses the knowledge and experience necessary to address restructuring challenges as well as operational ones. This scenario is dominated by the proverbial great company with a bad balance sheet (or a significant one-time liability) and the only restructuring involves fixing the right hand side of the balance sheet. These cases frequently use a pre-arranged or pre-pack bankruptcy to deal with their debt leverage issues. In such cases, a chief restructuring officer may not be not necessary to aid the board and management in exercising their duties and responsibilities as leaders of a debtor in possession.

The second, and equally uncommon, scenario involves those cases where existing management and directors have been exceptionally poor stewards of the company's assets. In cases involving fraud, dishonesty, incompetence, or gross mismanagement of the debtor's affairs by current management, § 1104 of the Bankruptcy Code directs the court to appoint a trustee to assume the duties, powers, and responsibilities of a debtor in possession—including to take over management and operation of the debtor's business. Commensurate with the penalty it threatens, however, the burden of proof for appointment under § 1104 is properly high. These cases, too, are relatively few and far between. As with the first category, where a trustee has been appointed to assume responsibility for managing the debtor's business and concurrent restructuring effort, a chief restructuring officer is generally not necessary to assist in the process.[2] Indeed, in some cases the appointment of a CRO may help to insulate a debtor in possession against the appointment of a trustee.[3]

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[2] As an aside, the existence of a CRO in the case can sometimes help to insulate a debtor in possession against a motion for the appointment of a trustee, as the presence of the CRO often serves as a counterweight to allegations of mismanagement or incompetence by current management

[3] *See, e.g., In re The 1031 Tax Group, LLC*, 374 B.R. 78, 91 (Bankr. S.D.N.Y. 2007) (existence of a CRO "independent, unconflicted, and in no way beholden to prior management" was sufficient to refute a *prima facie* showing of "cause" based on prior management's misconduct).

The third, and most common, scenario involves a management team that understands the business but lacks specific restructuring or crisis management experience. These management teams need guidance on how to apply restructuring principals to their business to maximize results. Without a restructuring advisor, management is left to on-the-job training to fulfill the duties of a debtor in possession and to effectuate a successful restructuring. Yet simply retaining such expertise in an advisory role is not always enough. As I explain below, the crisis manager frequently needs the access and authority of an officer-level role to fully implement a restructuring.

<u>The Role of a CRO in the Bankruptcy Process</u>

Unlike a typical legal or financial advisor, the CRO—as a duly-appointed officer of the company—reports directly to the Board of Directors. In many cases there will be a reporting structure where the company CEO and the CRO both report to the Board of Directors. The Board of Directors is entrusted with the governance of the company and management can be conflicted from actions that may eliminate or reduce their jobs. The CRO has no vested interest in the outcome of the company, and can therefore typically maintain a greater degree of objectivity than is generally expected of a corporate officer or other insider as to the best course of action to maximize value, including liquidating the company if needed. The need for such expertise to be contained in an officer-level professional is a testament to the importance of the CRO's function at that particular moment in the lifecycle of the company. Just as professionals in other areas of expertise are appointed to officer positions to oversee finance (CFO), operations (COO), information technology (CIO), and other fundamental aspects of a business enterprise, so too is it sensible (indeed, necessary, at times) for a company to appoint an officer experienced in the restructuring process to guide the company through reorganization. A crisis is no time for a management team to learn restructuring in bankruptcy through on-the-job training.

While some might argue that the CRO's function could be carried out just as easily as an outside advisor (like other financial advisors or outside legal counsel), that misses the significance of the "officer" part of the CRO's role. Unlike other professionals, who may be hired by the company to lend their expertise and advice to senior management's efforts to execute the company's business plan, the CRO is frequently called upon to lead that business plan as it transitions from normal operations to crisis management and restructuring efforts. As it is difficult for an outside advisor to lead such an effort, the "officer" aspect of a CRO's title is particularly important to the ultimate success of the turnaround.

As a member of senior management, the CRO works side by side with existing management and enjoys a comparable level of transparency to others in senior positions in the company. As an officer, a CRO typically reports directly to the Board of Directors, which is critical to a CRO's ability to recommend management changes when necessary. This critical nuance is not lost on management teams, who appreciate that the CRO can make direct recommendations to the Board of Directors concerning the effectiveness of existing management.

Issues Concerning the Retention and Compensation of CROs

Various commentators in recent years have highlighted the fact that neither § 327 nor § 363 provides a proper statutory basis upon which to approve a CRO's employment, as has been noted by various **[courts and]** commentators over the years.[4] The problem lies in the fact that a

[4] *See*, *e.g.*, Cooley, Michael P., "Two Round Holes and One Square Peg: The Employment of Turnaround Consultants under §§ 327 and 363," 24 *ABI Journal* 42 (September 2005); Gwynne, Kurt F., "Employment of Turnaround Management Companies, Disinterestedness Issues under the Bankruptcy Code, and Issues under Delaware General Corporation Law," 10 *ABI Law Review* 673 (Winter 2002).

CRO is both an officer (traditionally hired either in the ordinary course of business or with court approval under § 363) and a "professional person" whose employment is subject to § 327. As a result, the retention of CROs in chapter 11 cases has become fraught with confusion.

Section 327 governs the employment of professionals—or "professional persons"—in Code parlance. Section 327(a) offers some examples of professional persons, including attorneys, appraisers, accountants, and auctioneers, and the case law has extended the scope of "professional persons" to other categories of professionals based on either a qualitative analysis or a quantitative one. Courts adopting the former approach generally limit the concept of a professional person to those who play a central role in administering the debtor's case.[5] Those employing a more quantitative approach define a "professional person" as one who is "given discretion or autonomy in some part of the administration of the debtor's estate.[6] Under either definition, a CRO—typically a financial advisor or crisis manager hired specifically to take charge of the implementation of the company's restructuring efforts—is almost certainly a professional person for purposes of § 327.

That might end the discussion for most, except that to be employed under § 327, a professional must also be a "disinterested person," as that term is defined in § 101(14). As it is currently drafted, however, "disinterestedness" requires that the person "is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor."[7] If the CRO has not yet been appointed at the time the Debtor seeks to employ them, § 101(14) may still be satisfied; however, that is rarely the case. Far more common in my experience is the situation in which the debtor—facing the exigencies of whatever crisis or crises

[5] *In re Seatrain Lines Inc.*, 13 B.R. 980, 981 (Bankr. S.D.N.Y. 1981); *In re Bicoastal Corp.*, 149 B.R. 216, 218 (Bankr. M.D. Fla. 1993).
[6] *In re Fretheim*, 102 B.R. 298, 299 (Bankr. D. Conn. 1989); *In re Semenza*, 121 56, 57 (Bankr. D. Mont. 1990).
[7] 11 U.S.C. § 101(14)(B).

precipitated the filing—has already engaged the turnaround professional and appointed them chief restructuring officer. Indeed, this initial CRO hiring often occurs prepetition as one of the company's first steps to manage the financial crisis. In such cases, the CRO—as an officer of the company—is no longer disinterested for purposes of § 101(14), and therefore ineligible for employment under § 327.

Thus precluded from employing CROs in many cases under § 327, corporate debtors have turned to § 363, which governs the use, sale, or lease of property of the estate and been construed by many courts to extend to the use of estate funds to hire and pay senior management—for example, a new chief executive officer or chief financial officer.[8] This effectively side-steps the "disinterestedness" problem, albeit at the expense of the compensation process, as the fee disclosure and approval requirements of §§ 330 and 331 and Bankruptcy Rules 2014 and 2016 technically apply only to professionals employed under §§ 327 and 1103. The compensation of an officer employed under § 363(b)—like any other transaction subject to court approval under § 363—is generally subject only to the relatively low hurdle provided by the business judgment rule.

In recent years, the so-called "Jay Alix Protocol" has emerged in the Delaware and Southern District of New York bankruptcy jurisdictions—and others—as the *de facto* procedure for the employment of CROs and the review and approval of their compensation. Now widely accepted and used by professionals, US Trustees, and courts alike, the Jay Alix Protocol originated in September 2001 as a negotiated settlement between the United States Trustee for Region 3 (Delaware) and Jay Alix & Associates to resolve disputes over the qualification and compensation of Jay Alix & Associates in the *Safety-Kleen* and *Harnischfeger* cases. Among

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[8] *See, e.g., In re Adelphia Communications Corp.*, 2003 WL 22316543, *29 (Bankr. S.D.N.Y. 2003) (applying §363(b) to evaluate the proposed employment of a new CEO and CFO).

other terms and provisions, the protocol permits JA&A and its affiliates to seek employment in a case either as a financial advisor pursuant to §327 or as a crisis manager pursuant to §363, but not both. It further prohibits the firm from switching to a different role (*e.g.*, from crisis manager to financial advisor) in the same case. The protocol, however, ultimately fails to resolve the underlying conflict between §§ 327 and 363 in the context of CRO employment and compensation.

<u>Suggested Reform</u>

The Commission's purpose is to "study and propose reforms to Chapter 11 and related statutory provisions that will better balance the goals of effectuating the effective reorganization of business debtors—with the attendant preservation and expansion of jobs—and the maximization and realization of asset values for all creditors and stakeholders." In my opinion, this presents an ideal opportunity to consider and propose revisions to the Bankruptcy Code designed to more fully acknowledge the role of the CRO as a key player in chapter 11 reorganizations and establish a proper framework for the employment and compensation of CROs in such cases.

Such a recognition could be accomplished through a variety of means in the Code, perhaps most easily by simply amending § 101(14)(B) to specifically exclude service as a chief restructuring officer from the list of activities that render a person "not disinterested." Such an amendment would affirm the company's need to obtain experienced, officer-level assistance to guide it through the restructuring process, while simultaneously clarifying for all parties the retention and compensation procedures associated with this role.

Of course, we could simply maintain the status quo, where CROs are hired in the interstices between the Code sections. While this has worked in recent years, this uneasy amalgamation of §§ 327 and 363 creates confusion over the applicability of the "disinterestedness" standard in this context and inserts a degree of unpredictability to the compensation process. The fact that this approach relies heavily on the Jay Alix Protocol, which was originally nothing more than a negotiated settlement between the US Trustee's office and one such restructuring advisor, further underscores the tenuous nature of the arrangement. Moreover, it leaves intact the possibility that courts may choose to enforce the statutes literally, potentially disqualifying CROs who were retained prepetition and thus fail to meet the disinterestedness test of § 101(14). As noted, all too often, a company in distress needs the assistance of an officer-level manager to provide restructuring expertise and experience *before* it seeks relief in chapter 11. Indeed, in the first instance I am often hired specifically in an attempt to *avoid* a chapter 11 filing. A statute that can be construed to penalize a company from employing such expertise *before* seeking relief in chapter 11 deprives companies of the ability to seek the help of a qualified restructuring advisor to assume the responsibilities of CRO when they need it most.

I thank the Commission for inviting me to speak here today. At this time I would be glad to entertain any questions you may have for me.