



**Financial Advisory Firms Whose Affiliate's Employees Served as Independent Officers or Directors of the Debtor Prepetition Should Be Retained Under Section 327(a) of the Bankruptcy Code**

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**Introduction**

The retention of financial advisors by chapter 11 debtors must be approved by a bankruptcy court.<sup>1</sup> Currently, debtors may file employment applications for financial advisors, whose affiliate's employees, prepetition, served as a chief restructuring officer ("CRO"), under two different sections of title 11 of the United States Code (the "Bankruptcy Code").<sup>2</sup> Under section 327(a), financial advisors must satisfy a stringent two-part test to be approved.<sup>3</sup> Alternatively, financial advisors may seek approval under section 363(b) pursuant to the J. Alix Protocol, a national settlement protocol developed by the United States Trustee Program (the "USTP").<sup>4</sup> Since its inception, the J. Alix Protocol has been cited by debtors and bankruptcy courts when seeking and granting employment application approval.<sup>5</sup> However, concerns over

<sup>1</sup> See *In re McDermott Int'l, Corp.*, 614 B.R. 244, 247 (Bankr. S.D. Tex. 2020).

<sup>2</sup> See *id.*

<sup>3</sup> See 11 U.S.C. § 327(a) (2018).

<sup>4</sup> See *In re McDermott*, 614 B.R. at 249–50.

<sup>5</sup> See generally *In re Nine W. Holdings, Inc.*, 588 B.R. 678, 683 (Bankr. S.D.N.Y. 2018); see also *In re K.G. IM, LLC*, 620 B.R. 469 (Bankr. S.D.N.Y. 2020).

the use of the J. Alix Protocol as “a tool to avoid transparency and create inequity” have courts reverting back to approving the retention of financial advisors under section 327(a).<sup>6</sup>

The United States Bankruptcy Court for the Southern District of Texas voiced concerns when a debtor initially filed an employment application pursuant to the J. Alix Protocol.<sup>7</sup> After amending its application to seek approval under section 327(a), the debtor received court approval to employ financial advisors, and the court found this second filing provided “a much-appreciated level of transparency.”<sup>8</sup>

This memorandum explores whether debtors should be permitted to retain financial advisors who served in prepetition roles under section 327(a) or the J. Alix Protocol. Part I evaluates the employment application process under section 327(a). Part II similarly analyzes applications filed under the J. Alix Protocol. Part III discusses each application’s effectiveness at providing transparency and equity and concludes debtors should file financial advisor employment applications under section 327(a).

## **I. The Stringent Requirements of Section 327(a)**

### *A. Section 327(a) Imposes A Higher Standard For Disclosure*

Section 327(a) of the Bankruptcy Code governs the employment of “professional persons.”<sup>9</sup> Professional persons are not disqualified for employment under section 327(a) solely due to their “employment by or representation of the debtor before the commencement of the case.”<sup>10</sup> Courts may approve the retention of professional persons who: (i) “do not hold or represent an interest adverse to the estate,” and (ii) “are disinterested persons.”<sup>11</sup> Both prongs of

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<sup>6</sup> *In re McDermott Int’l, Corp.*, 614 B.R.at 252.

<sup>7</sup> *See id.* at 147.

<sup>8</sup> *See id.* at 253.

<sup>9</sup> 11 U.S.C. § 327(a) (2018).

<sup>10</sup> 11 U.S.C. § 1107(b) (2018).

<sup>11</sup> 11 U.S.C. § 327(a).

this test must be satisfied to warrant court approval.<sup>12</sup> The Bankruptcy Code defines a “disinterested person” as someone who “(i) is not a creditor, an equity security holder, or an insider; (ii) is not and was not, within two years prior to the petition date, a director, officer or employee of the debtor; and (iii) does not hold a material adverse interest to the bankruptcy estate.”<sup>13</sup> A lack of disinterestedness and the imputation thereof is determined via a case-by-case approach.<sup>14</sup>

#### *B. Court Approval of Applications Under Section 327(a)*

The term “professional persons” is not statutorily defined, and courts have taken to two different analyses to conclude that financial advisors constitute professional persons.<sup>15</sup> Judges adopting a quantitative analysis limit “professional persons” to “those occupations which play a central role in the administration of the debtor proceeding, and not those occupations which are involved in the day-to-day mechanics of the debtor’s business.”<sup>16</sup> The qualitative analysis extends this categorization to employees that are “given discretion or autonomy in some part of the administration of the debtor’s estate.”<sup>17</sup> The vagueness of both approaches has prompted courts to consider factors centered on the individual’s duties, skills, and compensation when determining who qualifies as “professional persons.”<sup>18</sup> Generally, financial advisors are “professional persons” for the purpose of section 327(a).<sup>19</sup>

Recognizing a CRO as a “professional within the meaning of section 327(a),” the United States Bankruptcy Court for the Middle District of Florida approved a prepetition CRO’s

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<sup>12</sup> *See id.*

<sup>13</sup> 11 U.S.C. § 101(14) (2018).

<sup>14</sup> *See In re McDermott Int’l, Corp.*, 614 B.R. at 255.

<sup>15</sup> *In re First Merchants Acceptance Corp.*, 1997 Bankr. LEXIS 2245, \*1, \*6 (Bankr. D. Del. 1997).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at \*7.

<sup>18</sup> *See id.* at \*9–10; *see also In re Madison Management Group, Inc.*, 137 B.R. 275, 283–84 (Bankr. N.D. Ill. 1992).

<sup>19</sup> *See In re Madison Management Group, Inc.*, 137 B.R. at 283.

retention pursuant to section 327(a) irrespective of the debtors seeking approval under section 363(b).<sup>20</sup> The court referenced the hearing record, which “demonstrate[d] that [the CRO] and the firm [were] disinterested, [did] not hold an interest adverse to the Debtors, and [did] not represent an interest adverse to the Debtors.”<sup>21</sup> The CRO satisfied the two-prong test because he “and the firm [were] independent of the Debtors” and “had no prior dealings with the Debtors or their principles.”<sup>22</sup>

Applying the two-part test of section 327(a), the United States Bankruptcy Court for the Southern District of Texas also approved applications for the retention of financial advisory firms.<sup>23</sup> The prepetition employment of the firms by the debtor did not prevent their employment under section 327(a).<sup>24</sup> There were no allegations, and the court found no evidence of any adverse interest held by the financial advisory firms.<sup>25</sup> Although they rendered services prepetition, the firms were disinterested because no evidence was offered to suggest they were creditors, insiders, or possessed any other interested characteristic.<sup>26</sup> The court rejected the USTP’s argument that the individual advisor providing prepetition services to the debtor was not disinterested and that his status should be per se imputed to the firms.<sup>27</sup> The individual advisor was, in fact, disinterested because he “ha[d] never been employed by [the debtor].”<sup>28</sup> Even if the individual advisor lacked disinterestedness, no evidence was presented to suggest his disinterestedness status should be imputed to either firm.<sup>29</sup> No such per se imputation rule was

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<sup>20</sup> *In re Blue Stone Real Estate, Const. & Dev. Corp.*, 392 B.R. 897, 906–08 (Bankr. M.D. Fla. 2008).

<sup>21</sup> *Id.* at 901.

<sup>22</sup> *Id.* at 907.

<sup>23</sup> *See In re McDermott Int’l, Corp.*, 614 B.R. at 255.

<sup>24</sup> *See id.* at 253.

<sup>25</sup> *See id.* at 255.

<sup>26</sup> *See id.* at 254–55.

<sup>27</sup> *See id.*

<sup>28</sup> *Id.* at 254.

<sup>29</sup> *See id.* at 255.

inscribed into the Bankruptcy Code by Congress, and the court declined to read one in.<sup>30</sup> Since neither firm was alleged to hold an adverse material interest and the court determined the firms were disinterested, the two-prong test of section 327(a) was satisfied.<sup>31</sup>

## **II. Circumventing the Disinterestedness Requirement Through Approval Under The J. Alix Protocol**

### *A. The Creation of the J. Alix Protocol*

In 2001, the USTP objected to the post-petition retention of “chief restructuring officers (‘CROs’) and their firms where the CRO had served in the role prior to the bankruptcy filing.”<sup>32</sup> Due to the CRO’s prior involvement with the debtor, the USTP argued the CRO, and financial advisory firm via per se imputation, would lack disinterestedness and therefore be ineligible for employment under section 327(a).<sup>33</sup> Thus, the USTP created and implemented a non-binding policy known as the J. Alix Protocol to resolve its objections and approve employment applications.<sup>34</sup> To circumvent the disinterested requirement of section 327(a), debtors file their employment applications under section 363(b), which “does not specifically address the employment of professional persons.”<sup>35</sup> Section 363(b) states that “[t]he trustee after notice and a hearing, may use, sell, or lease, other than in the ordinary course of the business, property of the estate.”<sup>36</sup> In approving an application under section 363(b), a judge must only find the debtor has “a good business reason.”<sup>37</sup>

Over the last two decades, courts have adopted the USTP’s “national policy . . . of explicitly assenting to retention applications for management consultants pursuant to section

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<sup>30</sup> *See id.* at 254.

<sup>31</sup> *See id.* at 254–255.

<sup>32</sup> *In re McDermott Int’l, Corp.*, 614 B.R. at 249.

<sup>33</sup> *See id.* at 250.

<sup>34</sup> *See id.*

<sup>35</sup> *Id.*

<sup>36</sup> 11 U.S.C. § 363(b)(1) (2018).

<sup>37</sup> *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel)*, 722 F.2d 1063, 1071 (2d Cir. 1983).

363(b).”<sup>38</sup> So long as debtors comply with certain protocol requirements, bankruptcy courts will approve “the retention of distressed management consultants by a debtor.”<sup>39</sup> Firms may not assume more than one of these capacities in a single debtor bankruptcy case: “(i) crisis manager retained under Sec. 363, (ii) financial advisor retained under Sec. 327, (iii) claims agent/claims administrator appointed pursuant to 28 U.S.C. § 156(c) and any applicable local rules or (iv) investor/acquirer; and upon confirmation of a Plan may only continue to serve in a similar capacity.”<sup>40</sup> Firms are required to file reports with the court that “include the names and functions filled of individuals assigned.”<sup>41</sup> They must also disclose any conflicts of interest or material adverse interests of the firm, its affiliates or individuals.<sup>42</sup> Additionally, individuals appointed to executive officer positions must be approved by an independent board of directors.<sup>43</sup>

#### *B. Applications Filed Pursuant to the J. Alix Protocol*

The USTP and bankruptcy courts do not always agree on when the J. Alix Protocol should be used to approve financial advisor employment applications.<sup>44</sup> Although the USTP argued the application must be filed under section 327(a), the United States Bankruptcy Court for the Southern District of New York approved the employment application of an interim Chief Executive Officer filed pursuant to the J. Alix Protocol and section 363(b).<sup>45</sup> The court determined it was inappropriate to evaluate the application under section 327(a) because the

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<sup>38</sup> *In re Nine W. Holdings, Inc.*, 588 B.R. at 683.

<sup>39</sup> *Id.* at 688.

<sup>40</sup> United States Trustee Program, *Protocol for Engagement of Jay Alix & Associates and Affiliates*. JUSTICE.GOV. I.A (2004), [https://www.justice.gov/sites/default/files/ust/legacy/2014/08/11/J\\_Alix\\_Protocol\\_Engagement.pdf](https://www.justice.gov/sites/default/files/ust/legacy/2014/08/11/J_Alix_Protocol_Engagement.pdf).

<sup>41</sup> *Id.* at I.C.

<sup>42</sup> *See id.* at I.E.

<sup>43</sup> *See id.* at I.D.

<sup>44</sup> *See In re Nine W. Holdings, Inc.*, 588 B.R. at 695; *see also In re K.G. IM, LLC*, 620 B.R. at 486.

<sup>45</sup> *In re Nine W. Holdings, Inc.*, 588 B.R. at 695.

interim CEO and the financial advisory firm were not “professional persons.”<sup>46</sup> Alluding to a quantitative analysis of “professional persons,” the court stated the pre- and post-petition roles of the interim CEO and financial firm were “focused on running the business.”<sup>47</sup> Persons involved in day-to-day business mechanics do not qualify as “professional persons.”<sup>48</sup> Thus, the court turned to evaluate the debtor’s business judgment under section 363(b) and nullified the USTP’s argument that the interim CEO and financial advisory firm lacked disinterestedness and failed to meet the approval standards of section 327(a).<sup>49</sup>

The bankruptcy court reasoned that “[t]he business judgment of a debtor’s board in making a business decision” will not be second-guessed by a court so long as the board “acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.”<sup>50</sup> Hearing testimony clearly demonstrated that the retention of the interim CEO and financial advisory firm was pertinent to “preserve and maximize the value of the Debtors’ businesses,” so the court declined to second-guess the board’s judgment.<sup>51</sup> The application was also aligned with the J. Alix Protocol’s purpose of “preventing a consultant from using its position in one capacity to benefit itself in another capacity.”<sup>52</sup> Though the interim CEO served on a single subsidiary board prepetition, he did not serve on a board considering the financial advisory firm’s engagement letters or one approving the financial advisory firm’s compensation.<sup>53</sup> Since the financial advisors “complied with the core requirements of the

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<sup>46</sup> *See id.*

<sup>47</sup> *Id.*

<sup>48</sup> *See In re First Merchants Acceptance Corp.*, 1997 Bankr. LEXIS 2245 at \*6.

<sup>49</sup> *See In re Nine W. Holdings, Inc.*, 588 B.R. at 692–95.

<sup>50</sup> *Id.* at 692.

<sup>51</sup> *Id.*

<sup>52</sup> *See In re Nine W. Holdings, Inc.*, 588 B.R. at 689.

<sup>53</sup> *See id.*

Protocol in all material aspects,” approval of the application was consistent with the current policy on crisis and interim management.<sup>54</sup>

Two years later, the United States Bankruptcy Court for the Southern District of New York once again approved the retention application of a CRO filed pursuant to the J. Alix Protocol.<sup>55</sup> The bankruptcy court considered the “heavily negotiated agreement” between the debtor, CRO, and financial advisory firm as evidence of a sufficient “level of a reasonable business judgment as required by section 363.”<sup>56</sup> The court dismissed the USTP’s objections that the CRO was not disinterested by reiterating that the J. Alix Protocol and section 363(b) contain no such disinterested requirement.<sup>57</sup> Though the J. Alix Protocol specifically addresses the need for a board of directors, the court stated that the debtors’ “lack of a board of directors [did] not categorically preclude them from utilizing a CRO during their chapter 11 case” because the protocol is not law.<sup>58</sup> Since the J. Alix Protocol is not binding, it “should not be read mechanically.”<sup>59</sup> The court approved the application and commented that it was “consistent with the Protocol’s spirit, in the best interests of the estate, and sought in the sound business judgment of the Debtors.”<sup>60</sup>

### **III. While the J. Alix Protocol Generates Confusion, Section 327(a) Provides Courts the Necessary Oversight to act in the Best Interests of Debtors**

In offering an alternative method for seeking retention application approval, the J. Alix Protocol “has become a tool to avoid transparency and create inequity.”<sup>61</sup> Because section 363(b) does not specifically address the employment of professional persons, it contains no language

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<sup>54</sup> *Id.* at 690.

<sup>55</sup> *See In re K.G. IM, LLC*, 620 B.R. at 486.

<sup>56</sup> *Id.* at 487.

<sup>57</sup> *See id.* at 486.

<sup>58</sup> *Id.* at 487.

<sup>59</sup> *Id.*

<sup>60</sup> *Id.* at 487.

<sup>61</sup> *In re McDermott Int’l, Corp.*, 614 B.R. at 252.

addressing “the conditions under which a professional person may be employed.”<sup>62</sup> The generality of section 363(b) provides applicants an opportunity to “push more and more services” through its umbrella “to avoid court oversight through the fee application process and the accompanying public transparency.”<sup>63</sup> The USTP has objected to the use of its own protocol and been overruled by bankruptcy courts, exemplifying the confusion generated by the J. Alix Protocol.<sup>64</sup> When challenging its use, the USTP has characterized the J. Alix Protocol “as a ‘backdoor’ way to avoid the limitations of section 327(a).”<sup>65</sup>

Selective compliance “with the protocol’s requirement’s requirements” also contributes to a lack of transparency and equity in the application process.<sup>66</sup> Courts have approved applications despite a debtor’s a lack of adherence to all of the protocol’s policies because it’s believed the debtor acts pursuant to the protocol’s spirit.<sup>67</sup>

Compared to the initial application under section 363(b), the United States Bankruptcy Court for the Southern District of Texas found the amended application under section 327(a) more transparent because it unbundled the confusing “triangular relationship between the parties.”<sup>68</sup> Similarly, a financial advisor seeking approval via the J. Alix Protocol was approved under section 327(a) because the court said the protocol does not permit courts “the same ability to meet the twin goals of section 327 when the candidate for employment is also a professional.”<sup>69</sup> These twin aims are “to permit the Court to control administrative expenses in

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<sup>62</sup> *Id.* at 249.

<sup>63</sup> *In re K.G. IM, LLC*, 620 B.R. at 253.

<sup>64</sup> *See In re Nine W. Holdings, Inc.*, 588 B.R. at 683.

<sup>65</sup> *Id.* at 690.

<sup>66</sup> *In re McDermott Int’l, Corp.*, 614 B.R. at 252 (noting that debtors filing under section 363(b) may only provide invoices to limited parties or inappropriately categorize financial advisory services as “back office” support services).

<sup>67</sup> *See In re K.G. IM, LLC*, 620 B.R. at 487.

<sup>68</sup> *In re McDermott Int’l, Corp.*, 614 B.R. at 253.

<sup>69</sup> *In re Blue Stone Real Estate, Const. & Dev. Corp.*, 329 B.R. at n.14.

the form of professionals' compensation and ensure that the professional is conflict free and impartial.”<sup>70</sup>

By requiring debtors to retain financial advisors under section 327(a), bankruptcy courts can hold debtors and financial advisors to a higher standard and receive more information regarding their employment agreement.<sup>71</sup> With this greater insight, bankruptcy courts can make a better determination regarding the financial advisor’s disinterestedness and take into consideration the financial advisor’s value.<sup>72</sup>

## **Conclusion**

The J. Alix Protocol “is not law, and it is not binding” on any court.<sup>73</sup> Though created as a pathway to approve post-petition employment of financial advisors who provided services prepetition, this protocol has become a way for debtors to attempt to evade court oversight.<sup>74</sup> Since developing this protocol, the USTP has challenged its use by debtors in certain circumstances and has even argued that professional persons may not be employed under section 363(b), a direct contradiction to the J. Alix Protocol.<sup>75</sup> This only promotes confusion in “a process that demands complete transparency.”<sup>76</sup> Furthermore, this protocol is unnecessary given the Bankruptcy Code’s explicit guidelines under section 327(a) for the employment of professional persons, which encompasses financial advisors.<sup>77</sup> Prepetition financial advisor applications do not automatically fail the disinterestedness requirement of section 327(a); therefore, debtors can and should file under section 327(a) when seeking court approval of their

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<sup>70</sup> *Id.*; see also *In re McDermott Int’l, Corp.*, 614 B.R. at 255.

<sup>71</sup> See *In re McDermott Int’l, Corp.*, 614 B.R. at 253.

<sup>72</sup> See *id.* at 248.

<sup>73</sup> *In re Nine W. Holdings, Inc.*, 588 B.R. at 688.

<sup>74</sup> See *In re McDermott Int’l, Corp.*, 614 B.R. at 253.

<sup>75</sup> See *In re Nine W. Holdings, Inc.*, 588 B.R. at 691.

<sup>76</sup> *In re McDermott Int’l, Corp.*, 614 B.R. at 253.

<sup>77</sup> See *id.*; see also *In re Madison Management Group, Inc.*, 137 B.R. at 283.

post-petition employment applications.<sup>78</sup> Filing these applications under section 327 eliminates confusion and provides bankruptcy courts “a much-appreciated level of transparency.”<sup>79</sup>

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<sup>78</sup> *See id.* at 255.

<sup>79</sup> *See id.* at 253.