UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEW MEXICO

In re:

FURR'S SUPERMARKETS, INC. Case No. 11-01-10779 SA
Tax I.D. No. 22-3137244

Debtor.

UNITED STATES TRUSTEE'S`BRIEF IN SUPPORT OF OBJECTION TO APPLICATION FOR EMPLOYMENT OF PETER J. SOLOMON CO., LTD.

The United States Trustee for the District of New Mexico hereby submits the following brief in opposition to the Debtor's Application for Order Authorizing Employment of Peter J. Solomon Co., Ltd. (Application). The thrust of the U.S. Trustee's objections relate to (1) the apparent attempt to employ Peter J. Solomon Co. Ltd. (PJSC) pursuant to 11 U.S.C.§328(a) and thereby approve compensation without compliance with 11 U.S.C.§330 and (2) various provisions in the retention agreement which conflict with the express provisions of the Bankruptcy Code and its underlying policies, particularly with regard to the indemnity provisions. Because the indemnity provisions are particularly contrary to the status and responsibilities of bankruptcy professionals, the objections to that provision will be treated separately.

I. Relevant provisions of the Application to employ Peter J. Solomon Co. Ltd.

As set forth in the Application, the Debtor seeks to retain PJSC pursuant to the terms of a letter agreement, which is attached the Application of Bradley I. Dietz (The "Letter Agreement"). The letter agreement sets forth a complex schedule of compensation.

A. Provisions dealing specifically with compensation.

1. The Letter Agreement provides for: (a) a monthly fee of $150,000, (b) a "Restructuring fee" of $1.5 million, and (c) "Transaction fees" equal to 1.5% of "Aggregate

Consideration" with a minimum fee of $1.5 million. PJSC has further agreed to credit monthly fees, after the second month, to Restructuring or Transaction fees. See Supplemental Declaration of Bradley I. Dietz at ¶10 & 12.

2. The monthly fee of $150,000 is payable *in advance* on the first day of each month. See section 3(a), Letter dated February 26, 2001 from Peter J. Solomon Co. to Furr's Supermarkets, Inc. attached to the Application (hereafter Letter Agreement).

3. A fourth potential source of compensation is a "Financing Fee," the amount and terms of which are yet to be negotiated. Letter Agreement at Section 3 (b).

4. In a lengthy and convoluted definition of "Aggregate Consideration" to determine Transaction fees, PJSC includes "all cash, securities, contractual arrangements and other properties paid or payable directly or indirectly in connection with a Transaction...." However, the definition also includes, "In the event such Transaction takes the form of a sale of assets, Aggregate Consideration shall include (i) the value of any current assets not purchased, minus (ii) the value of any current liabilities not assumed." See Letter Agreement, Section 3(d), For purposes of determining the amount of the Transaction fee, it therefore appears that any equity remaining in the Debtor after a sale of assets could be used in the computations to increase the size of the Transaction fee.

5. PJSC is to be reimbursed for out-of-pocket expenses, "including without limitation the fees, disbursements and other charges of PJSC's counsel." Also to be reimbursed are expenses in connection with "data-processing." Letter Agreement at Section 5.

6. By the terms of the proposed retention, the fees proposed to be paid PJSC, "**are subject to review by the Bankruptcy Court only as provided by Section 328 of the Bankruptcy Code.**" Letter Agreement, Section 8 (a).

B. Information not disclosed in the Application.

1. Although the Letter Agreement sets forth a complex schedule for compensation, at no point is a disclosure made either in the Letter Agreement, or the Application, with regard to the scope and complexity of the assignment, its anticipated duration, or expected results.

2. Further, no disclosure is made with regard to the number and qualifications of PJSC personnel to be devoted to this employment, together with specific tasks to be performed by them during the expected duration of the employment. Neither is any disclosure made with regard to any other resources necessary for PJSC to perform under this retention agreement.

3. At no point is disclosure made as to the hourly billing rates of the PJSC professionals.

C. Provisions of the proposed retention contrary to Bankruptcy Code requirements or limiting the authority of the Court.

1. The Letter Agreement provides that the Debtor may not terminate the agreement with PJSC for a minimum of six months. Further, the same provision states that PJSC shall be entitled to all monthly fees accrued at the time of termination, without submission and approval of the fees by the Court. In addition, the provisions state that PJSC is entitled to Reorganization and/or Transaction fees after termination for a period of 12 months (if PJSC advised the debtor regarding a Reorganization or identified a party in reference to a Transaction), again without submission and approval of fees by the Court. See Letter Agreement, Section 7 as modified by Supplemental Declaration of Bradley I. Dietz at ¶ 17 (d).

2. The Letter Agreement contains a provision which expressly states that, “The Company acknowledges and agrees that the fees payable to PJSC hereunder are reasonable.” See Letter Agreement, Section 8 (a). The Debtor therefore waives any objection to fees prior to the rendition of services.

3. The Application states that compensation to PJSC shall be classified under 11 U.S.C.§§503 (b)(1)(A) & 507(a)(1). The result is to classify PJSC fees as “actual, necessary costs and expenses of preserving the estate...” and not as “compensation and reimbursement awarded under §330 (a).” 11 U.S.C. §503(b). Further, the classification under §507 (a)(1) may operate to give PJSC a priority status to other administrative claims in the event of a conversion to a chapter 7 proceeding.

4. The Application provides that with regard to advice rendered by PJSC, “[T]he Company [Debtor] agrees that such advice may not be relied upon by any other person, used for any other purpose, or reproduced, disseminated, quoted or referred to at anytime...without the prior written consent of PJSC.”Letter Agreement at ¶ 8 (f). Subsequently, PJSC consented to the following phrase being added to the provision, “or as required by the Bankruptcy Code; providing that the Company may share such advice with the Creditors Committee.” See Supplemental Declaration of Bradley I. Dietz at ¶ 17 (e).

5. The Application provides that, “all controversies arising from or relating to performance under this Agreement, shall be governed by and construed in accordance with the laws of the State of New York...” Letter Agreement at ¶ 8(i).

6. The Application provides that, “[T]he Company hereby waives trial by jury, rights of set-off, and the right to impose counterclaims in any lawsuit with respect to, in connection with or

arising out of this agreement..." Letter Agreement at ¶8 (j). Subsequently, PJSC agreed to exclude counterclaims from the scope of this section. See Supplemental Declaration of Bradley I. Dietz at ¶17 (g).

D. <u>Certain portions of the indemnification provisions.</u>

1. Attached to the Letter Agreement is Exhibit B, consisting of two pages of single spaced provisions in small font setting forth the indemnity agreement demanded by PJSC. All references below are to this provision, which shall hereinafter be referred to as the "Indemnity Provisions."

2. The Indemnity Provisions specify that the "Indemnified Parties" include, "PJSC and its affiliates, counsel and other professional advisers, and the respective directors, officers, controlling persons, agents and employees of each of the foregoing..." Letter Agreement at Exhibit B.

3. The term "losses" is defined to include, "any losses, claims or proceedings including stockholder actions, damages, judgments, assessments, investigation cost, settlement costs, fines, penalties, arbitration awards, other liabilities, cost, fees and expenses..."

4. "The Company [Debtor] also agrees that no Indemnified Party shall have liability (whether direct or indirect, in contract or tort or otherwise) to the Company for or in connection with advice or services rendered or to be rendered by an Indemnified Party pursuant to this Agreement, to the transactions contemplated hereby or in Indemnified Party's actions or in actions in connection with any such advice, services or transactions..."

5. The duty for indemnification shall apply unless claimed losses, "arose *solely* out of the gross negligence or bad faith of such Indemnified Party."(emphasis added).

6. If multiple claims are brought against an Indemnified Party in an arbitration, "[T]he Company agrees that any arbitration award shall be conclusively deemed to be based on claims as to which indemnification is permitted and provided for..."unless otherwise specifically stated in the award.

7. PJSC may require the Debtor to assume the defense of any action against it including employing and assuming the costs of counsel acceptable to PJSC.

8. In the event that any right relating to the indemnification agreement becomes unavailable, PJSC's liability will in no event exceed the amount of fees received by PJSC. Further, any liability for losses will be apportioned between PJSC and the Debtor to reflect "benefits received," which term is defined very favorably to PJSC. Only if this provision is invalidated, would liability be apportioned according to relative fault.

II. Peter J. Solomon Co., Ltd. has not demonstrated the reasonableness of the compensation which it has requested and PJSC should be subject to the requirements of 11 U.S.C.§330.

"The burden of proof to establish that proposed terms and conditions of employment are reasonable is on the moving party. The Court must be persuaded that the terms and conditions are in the interest of the estate." *In re Gillett Holdings, Inc.* 137 B.R. 452, 455 (Bankr.D.Colo.1991), citing *In re C & P Auto Transport, Inc.* 94 B.R. 682,686 (Bankr.E.D.Cal.1988). The Debtor therefore bears the burden of proving that the terms and conditions of the proposed retention of PJSC are reasonable.

Further, at least one court has held that employment applications by an investment banker/adviser:

> [M]ust present the scope and complexity of the assignment, its anticipated duration, expected results, required resources, the extent to which highly specialized skills may be needed and the extent to which they have them or may have to obtain them, projected salaries of participating professionals, billing rates and prevailing fees for comparable engagements, current retentions in bankruptcy by the retained firm, and any estimated lost opportunity costs due to time exigencies of the job.

In re Drexel Burnham Lambert Group, Inc. 133 B.R. 13 (Bankr.S.D.N.Y.1991).

In this case, none of the above factors have been addressed by PJSC in its employment application. Although PJSC has failed to provide this information, it requests that millions of dollars in fees be approved <u>in advance</u> of the services to be rendered. As set forth above, the Letter Agreement specifically states that the fees to be paid to PJSC, as well as the provisions of Exhibit B (Indemnity Provisions), "are subject to review by the Bankruptcy Court only as provided by § 328 of the Bankruptcy Code." See Letter Agreement, Section 8 (a). In other words PJSC does not want its fee structure reviewed by the Court or the other parties in the case, under 11 U.S.C. § 330(a), which imposes a reasonableness standard. Instead it seeks to have its entire retention agreement, which includes the compensation structure and the indemnification and limitation of liability provisions approved, and therefore subject to review only, if it can be proven that such provisions are improvident in light of developments not capable of being anticipated at the time of the fixing of such terms..." 11 U.S.C.§328 (a).

As stated by the court in *Drexel:*

> All investment bankers/advisers want sizable monthly retainers regardless of the size of the case, the party represented, or the complexity of the case. Mathematically a correlation of fees, cases, and clients shows at worst, incestuous fee setting practices or, at best, oligopolistic behavior. From our experience in this case, and others, it is clear that the investment banking community starts with the retainer and works backward, using a variety of non-bankruptcy criteria to defend the fee charged.

> Whenever we have dealt with investment bankers and financial advisers we have been left with a strong impression that for them the debtor is a cash cow to be milked, Chapter 11 the milking parlor, and the Judge the milking stool. 133 B.R. at 26.

When faced with an argument by two investment bankers that they should not be required to submit fee applications, one Bankruptcy Court in the Tenth Circuit stated as follows:

> This Court is persuaded that Smith Barney and DLJ must file legally sufficient applications for fees in the same manner and subject to the same basic statutory requirements as other professionals. As a general rule, investment bankers must be treated as other Section 327 professionals and should not be given extraordinary treatment absent a compelling reason to do so. *In re Gillett Holdings, Inc*. 137 B.R. 452, 457 (Bankr.D.Colo.1991).

Another court, facing the same issue stated as follows:

> This Court is unable to find any authority supporting the proposition that investment advisers are not subject to the mandate of Bankruptcy Rule 2016(a), which requires that an entity seeking compensation shall file an application setting forth a detailed statement of services rendered, time expended, and expenses incurred. While this Rule may not please the community of investment advisers, this Court is constrained to conclude that the Bankruptcy Rules are controlling, not the general policy or custom of the investment advisers which prevails in the operation of the business of investment bankers or advisers. *In re Hillsborough Holdings Corp*. 125 B.R. 837, 840 (Bankr.M.D.Fla.1991).

In addition to the highly suspect proposition that PJSC should be exempt from the requirements of §330, is the plain fact that it is virtually impossible to reach an informed judgment on the reasonableness of fees requested until such time as the services have been rendered. The Bankruptcy Code itself states that in determining reasonable compensation all relevant factors should be taken into consideration including (1) the time spent, (2) the rates charged, (3) whether the services were necessary or beneficial to the estate, (4) whether the services were performed within a reasonable time, and (5) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases outside of bankruptcy. 11 U.S.C.§330(a)(3).

Although PJSC argues that it receives this fee structure in non-bankruptcy cases, market rates charged outside of bankruptcy are but one factor in determining reasonableness. Several courts have sustained this position. *In re Hillsborough Holdings Corp*., supra (investment banker fee application denied due to lack of time records and evidence of benefit to the state); *In re Gillett Holdings, Inc*. supra (employment applications of two investment bankers requesting $175,000 per month denied, in part due to lack of justification for fees); *In re NBI, Inc*. 129 B.R. 212 (Bankr.D.Colo.1991) (reasonableness of professional fees evaluated on several factors including, within appropriate limits, cost of comparable non-bankruptcy services); *In re Zolfo*, 50 F.3d 253 (3rd Cir. 1995) (accounting firm failed to carry its burden of showing that its customary fees were warranted in Chapter 11 proceeding).

Given that a professional's customary fees are but one factor in determining reasonableness of compensation, no judgment can be reached at this time on that issue. That must await the submission of a fee application which demonstrates the nature, extent, and value of services which PJSC renders in this case.

In arguing against this position, the Debtor essentially contends that a firm's customary rates are the sole determining factor in awarding compensation. In support of this argument, the Debtor cites two cases, neither of which is so inflexible. In those cases, both courts recognized that a firm's billing rates are not binding on a bankruptcy court. As stated by the Third Circuit:

> The clearest path to that goal [compensating bankruptcy services on par with non-bankruptcy work] is to rely on the market, subject to the modification that the court will, in practical terms, act as a surrogate for the estate, reviewing the fee application much as a sophisticated non-bankruptcy client would review a legal

> bill. This modification is driven by the fact that, realistically speaking, the legal market functions imperfectly in bankruptcy, as the debtor 'client' and other interested parties are often unable or unwilling to contest the fees charged.

In re Busy Beaver, 19 F.3d 833,848 (3rd Cir.1994)

Similarly, the Eleventh Circuit stated as follows:

> This is not to say that a bankruptcy court must always move in lock step with the billing structure a law firm employs. Obviously it is a court's duty to reject a flawed, excessive or illegal billing methodology, and there may be special reasons articulated by a court for disallowing even cognizable expenses in light of the facts of a particular case.

In re Hillsborough Holdings Corp. 127 F.3d 1398, 1404 (11th Cir. 1997).

Further, it is interesting to note that the *Zolfo* case cited above is also a pronouncement of the Third Circuit, issued one year after the *Busy Beaver* decision. The fact that the Third Circuit in *Zolfo* affirmed a reduction of 12% in a accounting firm's New York rates underscores that a particular firm's customary rates are subject to scrutiny.

III. Certain provisions of the PJSC Application should be invalidated as violative of fiduciary duty and impinging on the authority of the Court.

The debtor-in-possession is a fiduciary. Commodity Futures Trading Commission v. Weintraub 471 U.S. 343,355, 105 S.Ct. 1986, 1994, 85 L.Ed.2d 372 (1985). Investment bankers, as estate professionals, are likewise fiduciaries. *In re Gillett Holdings Inc*. 137 B.R. at 458, *In re Allegheny International Inc.* 100 B.R. 244, 246 (Bankr.W.D.Pa.1989). As such, investment bankers have an obligation of fidelity, undivided loyalty and impartial service in the interest of creditors. *In re Allegheny International, Inc*., supra. The provisions in the Letter Agreement by which PSJC attempts to limit its liability and reliance on its advice is contrary to such duties. Further the provision waiving the DIP's right to jury trials and rights of set off, in effect constitutes an attempt to compromise future claims without notice and opportunity for objection by parties in interest.

In addition to the above, it has been held:

> Freedom of contract is necessarily limited in the bankruptcy context. Bankruptcy counsel and debtors are not at liberty to bargain away the rights and responsibilities of a debtor-in-possession, nor the protection afforded creditors and other parties in interest in a bankruptcy case, under the guise of freedom of contract. They cannot evade the jurisdiction of the Court by choice, nor limit exercise of the Court's discretion by fiat.

In re NBI, Inc., 129 B.R. 212 (Bankr.D.Colo.1991). Despite this, the terms of the Letter Agreement clearly seek to evade the Court's jurisdiction and/or limit the Court's discretion. The provisions include: (1) limitation of the right to terminate PSJC during the first six months of employment, (2) waiver of the right of the Debtor to object to the reasonableness of fees, (3) classification of PSJC's compensation as necessary estate costs and expenses as opposed to professional fees, and (4) purported authorization for payment of PSJC's attorneys without Court approval of employment and compensation. See *In re Gillette Holdings, Inc.* 137 B.R. at 460 (Bankruptcy estate professionals may not employ or pay other professionals without Court approval under 11 U.S.C. §§ 327-331). Further, while the above provisions may be permissible under New York law, they conflict with federal bankruptcy law. Therefore, the provision stating that the retention of PJSC is to be governed by the laws of New York should be modified to yield to the primacy of federal bankruptcy law.

It is the position of the United States Trustee that PJSC be retained only if it complies with the provisions of the Bankruptcy Code and Rules by providing the detailed information requested above, and by filing detailed time records and fee applications subject to review of the parties and a determination of reasonableness by the Court pursuant to 11 U.S.C. § 330. PJSC has provided no convincing authority for its position that its Letter Agreement should be approved pursuant to 11 U.S.C. § 328(a).

IV. Indemnification provisions are overbroad, overreaching and contrary to a bankruptcy professional's fiduciary responsibilities.

A. Summary of Argument

Contractual arrangements holding persons harmless for the damages caused by their negligence are disfavored in the law. Two aspects of the financial advisory services provided by PJSC should render its request for indemnification unacceptable here: the professional nature of the services called for and the setting where those services were to be performed. Each of these considerations provides a basis for invalidating the Indemnification Provisions entirely.

1. PJSC has offered to supply professional services to the debtor in possession, i.e., it has proposed to perform tasks that require a high degree of skill and care, based upon special learning and advanced knowledge. Indemnification requests tendered by professionals are looked upon with special, heightened disfavor. Financial advisors should be held to high standards of care analogous to those applicable to lawyers and underwriters; their high calling precludes any request to be held harmless for their negligence. *Erlich v. First Nat'l Bank of Princeton*, 208 N.J. Super. 264, 288, 505 A.2d 220, 233 (N.J. Super. L. 1984). "Indemnification is not consistent with professionalism." *In re Mortgage & Realty Trust*, 123 B.R. 626, 631 (Bankr. C.D. Cal. 1991). See, also, *Eichenholtz v. Brennan*, 52 F.3d 478, 484-86 (3d Cir. 1995); *In re Allegheny International,* 100 B.R. at 246 .

2. Indemnification of professional negligence, even if it were palatable elsewhere, is wholly inappropriate for the governance of conduct in the provision of professional services in a

Chapter 11 bankruptcy proceeding. In this highly regulated context, the professional providing services has the special legal obligations of a fiduciary both to the debtors in possession and their creditors. An attempt by a debtor in possession to indemnify a person for negligence in advance, without any possible way of ascertaining what harm might be done, is inconsistent with the duties of the debtors in possession to the creditors. *CFTC v. Weintraub*, 471 U.S. 343, 355 (1985); *Official Comm. of Unsecured Creditors of United Healthcare Sys., Inc. v. United Healthcare Sys., Inc. (In re United Healthcare Sys., Inc.)*, 200 F.3d 170, 177 n.9 (3d Cir. 1999), *cert. denied*, 530 U.S. 1204 (2000). What might be an acceptable arrangement in the ordinary commercial environment is frequently forbidden in such a fiduciary context. *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928) (Cardozo, C. J.).

B. The Conditions of Employment Submitted to the Court For Approval Are Not Presumptively Reasonable.

Prior to the instant litigation, in several published decisions, the courts have rejected indemnification arrangements for financial advisors. *See, In re Allegheny Int'l, Inc.,* 100 B.R. 244, 247 (Bankr. W.D. Pa. 1989) ("holding a fiduciary harmless for its own negligence is shockingly inconsistent" with standard of care required); *In re Mortgage & Realty Trust*, 123 B.R. 626, 63 (Bankr. C.D. Cal. 1991) ("[i]ndemnification is not consistent with professionalism"); *In re Drexel Burnham Lambert Group*, 133 B.R. 13, 27 (Bankr. S.D.N.Y. 1991) ("[s]imply stated, indemnification agreements are inappropriate); *In re Gillett Holdings, Inc.*,137 B.R. 452, 458 (Bankr. D. Colo. 1991) ("entirely improper and unacceptable").[1]

---

[1] But, see, *In re Joan and David Halpern Inc.*, 248 B.R. 43 (S.D. N.Y. Bankr. 2000), aff'd, S.D. N.Y. No. Civ. 00-3601 (Dec. 6, 2000) (2000 WL 1800690).

The retention of a financial advisor, or other professional, by a trustee or a debtor in possession performing the role of trustee,[2] is not a matter of right. The permission of the court must be sought. Only "with the court's approval" may the debtors "employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons *** to represent or assist the trustee in carrying out the trustee's duties under this title." 11 U.S.C. § 327(a). The court "may *** authorize the employment of a professional person under section 327 *** on any reasonable terms and conditions of employment ***." 11 U.S.C. § 328(a).

Approval of professional service contracts under sections 327 and 328 is a serious process. The application must thoroughly disclose all of the terms of employment. Fed. R. Bankr. Pro. 2014(a). *Id. See, also*, *Land v. First Nat'l Bank of Alamosa (In re Land),* 943 F.2d 1265, 1266-67 (10th Cir. 1991) (summarizing the scrutiny of professional service payments). The applicant must affirmatively establish the professional's qualifications, *In re Interwest Business Equipment, Inc.*, 23 F.3d 311, 318 (10th Cir.1994), and bears the burden of proving that the terms and conditions of retention are reasonable, *Zolfo, Cooper & Co. v. Sunbeam-Oster Co., Inc.*, 50 F.3d 253, 259 n. 5 (3d Cir. 1995). An active judicial scrutiny of the proposed retention agreement is required, inasmuch as any order by the "court to compensate the approved professional [will come] from the funds of the bankrupt debtor." *Baehr v. Touche Ross & Co. (In re Philadelphia Mortgage Trust)*, 930 F.2d 306, 309 (3d Cir. 1991). Under the Bankruptcy

---

[2] Where the debtor's management continues to run the insolvent business under court supervision in a Chapter 11 case, the debtor in possession must perform the duties of a trustee. 11 U.S.C. § 1107(a).

System, both the creditors[3] and the United States Trustee[4] may question a debtors' employment application. But, even in the absence of objections, the courts have an independent duty to review employment requests.[5] A term or condition of employment is not "reasonable," for purposes of § 328, simply because the parties agreed to it, or because it is not illegal under State law outside of the bankruptcy context. See NBI, Inc. supra.

C. Indemnification Provisions Are Inherently Inconsistent With The Professional Role of The Financial Advisors.

"Exculpatory contracts are not favored by the law because they tend to allow conduct below the acceptable standard of care." *Yauger v. Skiing Enterprises, Inc.*, 206 Wis.2d 76, 81, 557 N.W.2d 60, 62 (1996). See, also, *e.g., A to Z Applique Die Cutting, Inc. v. 319 McKibbin St. Corp.*, 232 A.D.2d 512, 649 N.Y.S.2d 26 (N.Y. A.D. 1996) (lease provision shielding

---

3 Unfortunately, in many cases the theory of "[c]reditor control in bankruptcy cases is a myth. Creditors take little interest in pursuing a bankrupt debtor. They are unwilling to throw good money after bad." H.R. Rep. No. 95-595, at 92 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6053 (footnote omitted).

4 United States Trustees are officials of the Department of Justice appointed by the Attorney General to supervise the administration of bankruptcy cases and trustees. See, 28 U.S.C. §§ 581-589 (specifying the powers of United States Trustees); *United States Trustee v. Columbia Gas Sys., Inc. (In re Columbia Gas Syst., Inc.)*, 33 F.3d 294, 296 (3d Cir. 1994) (United States Trustees oversee the bankruptcy process, protect the public interest, and ensure that bankruptcy cases are conducted according to law)(citing H.R. Rep. No. 95-595, 109 (1977)); *United States Trustee v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 898 F.2d 498, 499 (6th Cir. 1990) ("[t]he United States trustee, an officer of the Executive Branch, represents *** [the] public interest").

5 *Cf., Matter of Kirkpatrick & Lockhart (In re Busy Beaver Building Centers, Inc.)*, 19 F.3d 833, 841 (3d Cir. 1994) (the "bankruptcy court has a duty to review fee applications, notwithstanding the absence of objections by the United States Trustee, creditors, or any other interested party, a duty *** which *** derives from the court's inherent obligation to monitor the debtor's estate and to serve the public interest."); *In re Interwest Business Equipment, Inc.*, supra, 23 F.3d at 316.

landlord negligence void as against public policy); *Borg-Warner Ins. Fin. Corp. v. Executive Park Ventures,* 198 Ga.App. 70, 400 S.E.2d 340 (Ga. App. 1990) (lease provision shielding tenant negligence void as against public policy).

> *** It is not the rule that any agreement by any person which assumes to place another person at the mercy of his own faulty conduct is void as against public policy. *** However, the law does not look with favor on provisions which relieve one from liability for his own fault or wrong ***.

17 Am. Jur. 2d, Contracts § 297 & n.72 (1991).

Where professional services are at issue, the arrangement cannot be regarded as a purely commercial one. A "profession" is a "vocation or occupation requiring special, usually advanced, education, knowledge, and skill; *e.g.* law or medical professions." Black's Law Dictionary 1089 (5th ed. 1979). A professional person is charged with exercising a special degree of care in the discharge of his or her work, reflecting that special attainment.[6] For anticipated professional conduct, a higher calling, requests to be excused the consequences of negligence are viewed as unseemly. "It is tacky, to say the least, for a professional to hide behind such a clause." *In re Healthco Int'l., Inc.,* 195 B.R. 971, 987 (Bankr. D. Mass. 1996) (financial advisory services).[7]

In the legal profession, it has long been accepted that it is inappropriate for a professional to accept any form of indemnification from its client. The profession's rules of ethics prohibit attorneys from accepting indemnity in connection with professional services. Model Code of

---

[6] See, *e.g.*, *Johnson v. State*, 37 S.W. 3d 191 (Ark. S. Ct. 2001) (policemen); *Dayton Bar Ass'n v. Baker*, 711 N.E.2d 661 (S.Ct. Ohio) (*per curiam*) (lawyers); *Jerry Clark Equipment, Inc. v. Hibbits*, 612 N.E. 2d 858, 863 (Ill. App. 5th Dist. 1993) (accountants); *French Drug Co. v. Jones*, 367 So.2d 431 (S.Ct. Miss.1978) (druggists).

[7] In *Healthco*, the court expressly agreed with the bankruptcy cases, supra, refusing to approve indemnification clauses. 195 B.R. at 987 & n. 64. The court distinguished between bankruptcy approval and judicial enforcement of a prepetition agreement.

Professional Responsibility DR 6-102; Model Rules of Professional Conduct Rule 1.8(h); *see also In re Mortgage & Realty Trust*, 123 B.R. 626, 630 (Bankr. C.D. Cal. 1991) ("ethics rules prohibit an attorney from obtaining an indemnity from a client in connection with professional services"). Under the Model Code of Professional Responsibility DR 6-102, a lawyer is prohibited from even attempting "to exonerate himself from or limit his liability to his client for his personal malpractice." See, also, e.g., *Porubiansky v. Emory Univ.*, 156 Ga. App. 602, 275 S.E.2d 163 (Ga.App. 1980), aff'd *sub nom. Emory University v. Porubiansky*, 248 Ga. 391, 282 S.E. 2d 903 (S. Ct. Ga. 1981) (dentists). *Cf.*, *Valhal Corp. v. Sullivan Assocs., Inc.,* 44 F.3d 195, 202-04 (3d Cir. 1995).[8]

Financial advisors who hold themselves out to be professionals, and who are subject to the same standards of scrutiny under §§ 327 and 328, must be subjected to similar strictures. The degree of learning and skill brought to their task is similar. As with other professional negligence, a financial advisor's mistakes will often engender serious injuries; they can cause serious losses to the estate and even force a liquidation. See, *e.g.*, *In re Merry-Go-Round Enterprises, Inc.*, 244 B.R. 327, 330-31, 333 (Bankr. D. Md. 2000) (accounting firm, retained in chapter 11 case to provide services to the debtor as a "turnaround specialist," settles negligence, malpractice, fraud and fraudulent concealment suit brought by the estate for $185 million); *Billing v. Ravin, Greenberg & Zackin, P.A.,* 22 F.3d 1242 (3d Cir. 1994) (professional accused of malpractice for

[8] *Valhal*, a non-bankruptcy case, illustrates the judicial hesitation to approve the efforts of professionals to immunize themselves from the consequences of their negligence. The court enforced an exculpatory clause, but only because (a) the case involved a matter of private contract with no public interest implicated; (b) the parties were presumed to have equal bargaining power (architect/developer contract); (c) no fiduciary obligation was involved; and (d) the provision at issue was only a limitation of liability and not a comprehensive indemnification. None of those conditions are present here.

failing to perform a number of duties); *Southmark Corp. v Coopers & Lybrand (In re Southmark Corp.)*, 163 F.3d 925, 928 (5th Cir. 1999) (unsuccessful multimillion dollar malpractice action against accountants).

In voiding an exculpatory clause drafted by a financial advisor, the court in *Erlich v. First Nat'l Bank of Princeton*, 208 N.J. Super. 264, 288 505 A.2d 220, 233 (N.J. Super. L. 1984), concluded:

> Unlike doctors and lawyers, who are self-regulated, investment advisers who hold themselves out to the public as having special knowledge and skill are not self-regulated. This distinction does not justify a holding that they may contractually exculpate themselves from negligent advice. ***

Accordingly, there is no reason to treat professionals differently under section 327 of the Code. In this case, PJSC should be "entitled to no more *** protection than that afforded to other professionals employed by the Debtor," such as attorneys, and therefore it should not be authorized to obtain indemnification in advance . *In re Gillett Holdings, Inc.,* 137 B.R. 452, 458 (Bankr. D. Colo. 1991). See, also, *Realty Trust*, 123 B.R. at 630-31; *In re Drexel Burnham Lambert Group*, 133 B.R. at 27.

Under Section 327 of the Code, a professional can be employed only if its retention is necessary. If the debtors can perform those duties without assistance, it is improper to retain a professional. *Boldt v. United States Trustee (In re Jenkins),* 130 F.3d 1335, 1341 (9th Cir. 1997) ("Section 327 allows trustees to hire professionals to perform services requiring special expertise beyond that expected of an ordinary trustee ***."). Given that professionals provide important services, the bankruptcy system must ensure those "professionals would be especially diligent in making sure that they meet the standard of care for exercising their expertise in their work in the case." *Realty Trust,* 123 B.R. at 631. Since allowing indemnification clauses could tend to encourage professionals to ignore this standard of care, and would impair the ability of their debtor clients to recover on behalf of the creditors if the professional fails to perform its duties, courts should prohibit indemnification of professionals.

Substantial support for this conclusion is drawn from courts' refusal to allow securities underwriters to enter into indemnification contracts with their issuer clients. *Eichenholtz v. Brennan*, 52 F.3d 478, 484-86 (3d Cir. 1995) (court refused to uphold an indemnification contract because indemnification is inconsistent with the policies underlying the securities laws even though the provision did not violate any express statutory provision); *Gillman v. Continental Airlines (In re Continental Airlines),* 203 F.3d 203, 216 (3d Cir. 2000) (citing *Eichenholtz* with approval). See, also, *Globus v. Law Research Serv., Inc.,* 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970) (refusing to allow indemnification of an underwriter for reckless misconduct).

In *Eichenholtz*, several defendants settled a securities class action suit. *Eichenholtz,* 52 F.3d at 479-81. As part of the settlement agreement, the district court extinguished provisions in four contracts through which the securities issuer had granted indemnification rights to an underwriter that had not agreed to the class action settlement. *Id.*, 479-81, 484-86. The court of appeals affirmed. Before reaching the contractual question, the Third Circuit rejected the underwriter's argument that the securities laws gave it an implied right of action to obtain indemnification from the issuer. *Id.*, at 483-84. The court refused to find such a right because the securities laws are not primarily drafted to "protect the underwriters, but rather [to] protect investors." *Id.* at 483. The court held that indemnifying underwriters served no valid public purpose because it would be "the underwriters, not the victims, who [would] seek indemnification." *Id.* at 483-84.

The Third Circuit relied upon the same policy considerations in refusing to uphold the underwriter's contractual right to indemnification. *Id.* at 484-86. In four separate agreements, the issuer had contractually agreed to indemnify the underwriter "from any and all loss, liability, claims, damage, and expense arising from any material misstatement, untrue statement, or omission." *Id*. at 484. This included the underwriter's "negligent *** performance of its duties." *Id*. The court refused to sanction these contracts because they undercut the underwriter's incentive to perform its duties competently. *Id.* at 484-86.

The court noted that "[t]he underlying goal of securities legislation is encouraging diligence and discouraging negligence in securities transactions." *Id.* at 484. It held "[t]hese goals are accomplished by exposing issuers and underwriters to the substantial hazard of liability for compensatory damages." *Id.* (internal quotation marks omitted).[9] This is so because "an underwriter indemnification provision *** would effectively eliminate the underwriter's incentive to fulfill its" duties. *Id.* at 485. Because "contractual indemnification" "allows an underwriter to

---

[9] Accord, *Globus*, 418 F.2d at 1288 (citing the "'*in terrorem* effect' of civil liability"). As the *Globus* court noted, prohibiting the indemnification of underwriters:

> ensures that an underwriter will not be able to increase the issuer's liability while totally avoiding any injury to himself. In both instances, the proper purpose of the Act is to encourage diligence, investigation and compliance with the requirements of the statute by exposing issuers and underwriters to the substantial hazard of liability for compensatory damages.

Id. at 1289.

shift its entire liability to the issuer," it impermissibly diminishes an underwriter's incentive to perform its duties and cannot be upheld. *Id.*

The logic of *Eichenholtz* fully applies to bankruptcy professionals. Like underwriters, bankruptcy professionals are hired to assist their clients in their dealings with third parties who "depend" on the professionals' work.[10] The "incentive" of bankruptcy professionals to accomplish their important tasks would be just as "effectively eliminated" if they could obtain indemnification as would that of an underwriter.

For these reasons, bankruptcy professionals "may not absolve themselves of such a broad range of potential liability or responsibility for their own actions." *Gillett*, 137 B.R. at 458. This appeal should not construed to be directed against PJSC, in particular, among professional financial advisors. Rather, "[s]imply stated, indemnification agreements are inappropriate." *Drexel,* 133 B.R. at 27.

D. INDEMNIFICATION PROVISIONS ARE ESPECIALLY INAPPROPRIATE IN COURT-SUPERVISED BANKRUPTCY ACTIVITIES.

As shown above the indemnity, Indemnification Provisions requested by PJSC should be disallowed because of the judicial policies respecting the standards of conduct demanded from professionals. Those Indemnity Provisions should also be voided on the independent basis that PJSC's provision of services as a professional financial advisor to the debtors in a bankruptcy proceeding imbues the firm with special legal and public duties.

---

[10] Indeed, the position of the creditors would render the logic of *Eichenholtz* even more compelling in the bankruptcy context. Unlike the typical public investor, the creditor in a bankruptcy proceeding is not there voluntarily and is not choosing to rely upon the financial advisor's advice.

"[A] contract for exemption from liability for negligence is void and unenforceable if it is violative of law or contrary to some rule of public policy ***." 17A C.J.S. Contracts § 262 at p. 268. Public policy considerations bar such arrangements "in the performance of a legal duty or a duty of public service, or where a public interest is involved or a public duty owed, or, when the duty owed is a private one, where public interest requires the performance thereon." *Id.*, at pp. 270-71. Or, as the court in *Rosenthal v. Bologna,* 211 A.D.2d 436, 437, 620 N.Y.S.2d 376, 377 (N.Y. A.D. 1995) (citation omitted) explained,

> *** Contractual clauses which purport to exculpate a party from liability for his own negligence are disfavored, and invite close judicial scrutiny. Normally, such exculpatory agreements will be upheld in a purely commercial setting, or where voluntary nonessential social activities are freely engaged in by consenting parties. ***

Needless to say, the services of the financial advisor in this case cannot be described as "nonessential." If the services are not essential, they should not be sought by the debtors nor approved by the Court – either with or without indemnification provisions. This dispute thus addresses the reasonable contractual parameters for indispensable, professional services required to maximize the chances for continued fiscal viability.

Nor can it be remotely said that PJSC will be providing its services in a "purely commercial setting." In a commercial setting, the parties would not be submitting the retention agreement to a federal court for a mandatory, independent review of its reasonableness. This transaction is submitted for sanction in the extremely regulated environment of Chapter 11 reorganization.

Bankruptcy fiduciaries have always been held to particularly high standards of honesty and loyalty. See, generally, *Woods v. City Nat'l Bank & Trust Co.*, 312 U.S. 262, 278 (1941) (trustees); *Mosser v. Darrow,* 341 U.S. 267 (1951) (same). *See, also*, *Meinhard v. Salmon*, 249

N.Y. 458, 464, 164 N.E. 545, 546 (1928). As Chief Judge Cardozo explained in *Meinhard,* "[m]any forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties." *Id.* In the workaday world of solvent companies, it may be appropriate for some companies to bestow indemnity on their professionals. But, in a bankruptcy proceeding, it is improper for a provider of professional services, seeking court approval under §327, to seek a blank check that may wind up being drawn on the bank accounts of its creditors.

In the course of enacting the Bankruptcy Reform Act of 1978, the legislators explained:

> The practice in bankruptcy is different for several reasons. First, there is a public interest in the proper administration of bankruptcy cases. Bankruptcy is an area where there exists a significant potential for fraud, for self-dealing, and for diversion of funds. In contrast to general civil litigation, where cases affect only two or a few parties at most, bankruptcy cases may affect hundreds of scattered and ill-represented creditors. In general civil litigation, a default by one party is relatively insignificant, and though judges do attempt to protect parties' rights, they need not be active participants in the case for the protection of the public interest in seeing disputes fairly resolved. In bankruptcy cases, however, active supervision is essential. Bankruptcy affects too many people to allow it to proceed untended by an impartial supervisor.

H.R. Rep. No. 95-595, at 88 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6050 (footnotes omitted). *Cf., Gunter v. Ridgewood Energy Corp.*, 223 F.3d 190, 191-92 (3d Cir. 2000) (requiring district courts to engage in a thorough and independent review of fee requests in common fund cases).

Perhaps prior to seeking the substantial protections afforded a bankrupt, neither debtors nor their officers and directors owed any special duty to their corporations' creditors in determining how much to pay their professionals. See, e.g., *C-T of Va., Inc. v. Barrett*, 124 B.R. 689, 692-93 (W.D. Va. 1990) (under Delaware law, directors have no special duty to their creditors); *Simons v. Cogan,* 549 A.2d 300, 304 (Del. 1988) (under Delaware law, directors owe no special duty to debenture holders). But this totally changed when the debtor sought protection under Chapter 11 of the Bankruptcy Code. In becoming a debtor in possession, Furr's accepted the mantle of fiduciary, thereby obligating itself to perform its duties in the way that best serves the interests of its creditors. *CFTC v. Weintraub*, 471 U.S. 343, 355 (1985) (holding debtors in possession have a fiduciary duty to their creditors); *Official Comm. of Unsecured Creditors of United Healthcare Sys., Inc. v. United Healthcare Sys., Inc. (In re United Healthcare Sys., Inc.),* 200 F.3d 170, 177 n.9 (3d Cir. 1999), *cert. denied*, 530 U.S. 1204 (2000) (applying *Weintraub* and 11 U.S.C. § 1107(a) to hold "a debtor-in-possession is a fiduciary for its estate and its creditors").

"Indeed, the willingness of courts to leave debtors in possession 'is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee.'" *Weintraub*, 471 U.S. at 355 (quoting in part *Wolf v. Weinstein*, 372 U.S. 633, 649-52 (1963)). Debtors in possession must perform their duties more carefully than entities who are not in bankruptcy because their actions are more fraught with risk. If a solvent corporation takes risks, only its owners normally bear the loss of a rash or improvident decision. Simply by being in bankruptcy, it is a given that the debtors cannot or may not be able to meet all anticipated financial obligations. Accordingly, a lost wager, which might hurt only a solvent company's owners, will hurt innocent third parties in chapter 11 cases - the debtors' lawful creditors. When a company files for bankruptcy, it must recognize it is no longer playing with the house's money. It's now gambling with the creditors'.

For these reasons, the law requires debtors in possession to consider not whether they are willing to take a risk but whether taking that risk could adversely affect creditors. Inasmuch as they are fiduciaries, they must now "exercise control" over the "management" of the company in a way that fairly protects the interests of the estates' creditors. *Weintraub,* 471 U.S. at 356 (debtor in possession must manage attorney-client privilege in a way that is consistent with the "obligation to treat all parties, not merely the shareholders, fairly"). This means the debtor in possession is required to satisfy itself that it is acting fairly to the creditors before it seeks to bestow indemnification upon PJSC. *Everett v. Perez (In re Perez)*, 30 F.3d 1209, 1214 (9th Cir. 1994) (chapter 11 debtor must satisfy itself that cramdown is proper before so certifying to the court). The debtor in possession in this case has failed to meet that requirement.

It is important to bear in mind that potential negligence claims against a financial advisor would be property of the estate. 11 U.S.C. § 541(a)(7). Absent the promise of indemnification, debtors in possession would have a fiduciary duty to seek recovery, for the benefit of its creditors, from a negligent financial advisor for that loss. See, generally, *Integrated Solutions, Inc. v. Service Support Specialities, Inc.,* 124 F.3d 487, 491 (3d Cir. 1997); *Billing v. Ravin, Greenberg & Zackin, P.A.,* 22 F.3d 1242 (3d Cir.), *cert. denied*, 513 U.S. 999 (1994); *In re Thompson*, 116 B.R. 679, 682 (Bankr. W.D. Ark. 1990). Inasmuch as estate property may be sold only when an estate's creditors will benefit, the law imposes a fiduciary duty upon debtors in possession to conserve claims and commands them to take necessary affirmative actions to realize upon such claims for the benefit of their creditors. *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 474 (3d Cir. 1998) ("among the fiduciary obligations of a debtor-in-possession is the 'duty to protect and conserve property in its possession for the benefit of creditors'") (quoting in part *In re Ionosphere Clubs, Inc.*, 113 B.R. 164, 169 (Bankr. S.D.N.Y. 1990)). *See, also*, *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 12 (2000) (noting that a trustee

- and thus by inference a debtor in possession - must pursue a claim under 11 U.S.C. § 506(c) because "the trustee is obliged to seek recovery under the section whenever his fiduciary duties so require"). Indeed, not only would the debtor in possession "have a strong incentive to pursue" such claims, "but both the trustee and the debtor in possession have a fiduciary duty to pursue viable § 506 claims that would benefit the estate." *Ford Motor Credit Co. v. Reynolds & Reynolds Co. (In re JKJ Chevrolet, Inc.)*, 26 F.3d 481, 485 (4th Cir. 1994).[11] The debtor in possession in this proceeding, by agreeing to the indemnification provisions sought by PJSC, is failing in this regard.

Bankruptcy does not allow a debtor in possession to give up a potentially valuable claim when the debtor has no idea what it might be worth. To the contrary, to ensure that estate property is sold only for full value, all sales are conditioned upon "notice, a hearing, and a court determination that the [sale] is in the best interests of the estate." *Northview Motors, Inc. v. Chrysler Motors Corp.,* 186 F.3d 346, 350-51 (3d Cir. 1999) (construing 11 U.S.C. § 363). This is not a case where a debtor wants to sell an asset after it has extensively marketed it, appraised it, and solicited bids. Here, the debtor in possession proposes to give up a right to seek a recovery for its creditors with no notion of what that right might be worth. The indemnification arrangements are thus objectionable not only because they encourage a standard of care that is inconsistent with an investment banker's fiduciary obligations to the creditors; the indemnification provisions are also inconsistent with the obligations of the debtor in possession regarding the prudent management of estate property.

---

11 *Cf. Myers v. Martin*, 91 F.3d 389, 394 (3d Cir. 1996) ("it is the trustee's duty to both the debtor and the creditor to realize from the estate all that is possible for distribution among the creditors") (quoting 4 *Collier on Bankruptcy* ¶ 704.01 15th ed. 1993).

Conclusion

The United States Trustee respectfully requests that the employment application for PJSC be denied until and unless PJSC provides the additional information requested herein and otherwise complies with the requirements for retention under 11 U.S.C. § 327(a) and further complies with the provisions of 11 U.S.C. §§ 330 and 331 by providing detailed time records and fee applications subject to review of the parties and approval by the Court in this case as to reasonableness of the fees requested pursuant to 11 U.S.C. § 330. Further, the provisions discussed above which do not comply with Bankruptcy Code requirements or seek to limit the jurisdiction of the Court, should be voided. In particular, the Indemnity Provisions should be voided in their entirety as being inconsistent with the fiduciary obligations of PJSC and the Debtor-in-Possession.

Respectfully submitted,

BRENDA MOODY WHINERY
United States Trustee

Filed electronically 5/14/01
Ron E. Andazola
Assistant United States Trustee
Post Office Box 608
Albuquerque, NM 87103
(505) 248-6544

The undersigned certifies that a true and accurate copy of the foregoing was mailed to the below listed counsel this 14th day of May, 2001.

Filed electronically 5/14/01
Ron E. Andazola

Robert H. Jacobvitz, Esq.
Jacobvitz, Thuma, & Walker
500 Marquette NW, Suite 650
Albuquerque, New Mexico 87102
(505) 766-9272

William F. Davis, Esq.
Davis & Pierce, P.C.
201 Broadway SE
P.O. Box 6
Albuquerque, NM 87103
(505) 243-6129

Paul Fish, Esq.
Modrall, Sperling, Roehl, Harris & Sisk P.A.
500 Fourth Street, N.W. Suite 1000
Albuquerque, N.M. 87103-2168
(505) 848-1800

Jennie Deden Behles, Esq.
J.D. Behles & Associates
400 Gold Ave. S.W., Suite 400
Albuquerque, N.M. 87103-0849
(505) 243-9756