VI Financial Advisors & Turnaround Consultants

It has been observed that large chapter 11 cases have become increasingly "professionalized."[176] In particular, while once debtor's counsel might have handled the bulk of the reorganization, the debtor now routinely retains specialized professionals to address specific aspects of the case.

Among the most controversial of these non-legal professionals have been the financial advisors, as they often earn transaction fees based on either the sale or reorganization of the debtor.[177] Specifically, financial advisors are typically compensated with a combination of flat monthly fees and outcome contingent transactional fees, and thus fit uneasily into the American chapter 11 system, which is largely dominated by lawyers, and former lawyers acting as judges, both of whom are most accustomed to billing hourly rates plus expenses.[178]

Bankruptcy financial advisors come in two broad types. First there are the investment banker-type advisors, who either help market (i.e. find a buyer for) the debtor or advise the debtor on business changes going forward.[179] Alternatively, if retained by a committee they provide advice about the debtor's business prospects and the financial terms of the proposed plan. Second there are the accounting firms that act as financial advisors. They typically provide similar business advice to either the debtor or the committee that retains them, but are less likely to engage in direct efforts to sell the debtor. In addition, both types of financial advisor typically present valuation evidence at the hearing to consider a reorganization plan for the debtor.[180]

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176 Jo Ann Brighton et al., *For Better Or Worse: Chapter 11 In The Post-BAPCPA Downturn*, 7 DePaul Bus. & Com. L.J. 555, 578 (2009).

177 http://www.bloomberg.com/apps/news?pid=20601087&sid=apzbxu6eOxik. *See* In re Hillsborough Holdings Corp., 125 B.R. 837 (Bankr. M.D. Fla. 1991).

178 Michael L. Cook & Stephen J. Lubben, *Retention, Payment, Ethical And Other Obstacles For Non-Legal Professionals In Chapter 11 Reorganizations*, 66 PLI/NY 175 (1999) ("Courts throughout the country differ in their views of non-legal professionals. Retention arrangements that are routinely approved in Manhattan and Wilmington may be met with skepticism, if not outright hostility, in Los Angeles, Denver, or Tampa.").

179 Until 2005, these firms were typically not the large, well-known American investment banks, as the Bankruptcy Code expressly precluded retention of an investment banker that had been an underwriter for the debtor's securities. In addition, it should be noted that financial advisors retained in chapter 11 cases only rarely underwrite securities offerings, so some would argue they are not actually "investment bankers."

180 For example, in all cases the debtor is required to prove that creditors are receiving at least as much as they would in a hypothetical chapter 7 liquidation. 11 U.S.C. §1129(a)(7). This requires the creation of a "liquidation analysis" and presentation of the same at the hearing. *See* Peter V. Pantaleo & Barry W. Ridings, *Reorganization Value*, 51 Bus. Law 419 (1996).

Somewhat related to the financial advisors are the turnaround consultants.[181] These are professionals retained by the debtor. Like financial advisors, they provide business advice to the debtor – indeed, some of the same firms act as financial advisors when retained by a committee. But these turnaround consultants typically become more involved in the direct management of the debtor, often taking positions within the senior management of the debtor. In some instances, the retention of these firms is mandated by a senior lender or the lead lender for the group of banks in the debtor's secured credit facility. Appointment of a turnaround firm and a member of that firm as "chief restructuring officer" is sometimes the price for obtaining additional financing during a chapter 11 case.[182] In other cases, turnaround firms, despite their hopeful names, provide the management of a remnant debtor following an asset sale, liquidating unsold assets, and working toward a plan that will distribute the sale proceeds.

There are 33 turnaround firms retained in the present dataset, across 30 chapter 11 cases. That is, in three cases debtors retained two turnaround firms, while 27 debtors retained a single turnaround firm. 33 fee applications is often an insufficient number to analyze separately, but given the somewhat unique role these professionals play, it warrants accounting for their presence when considering the topic of financial advisors, broadly defined.

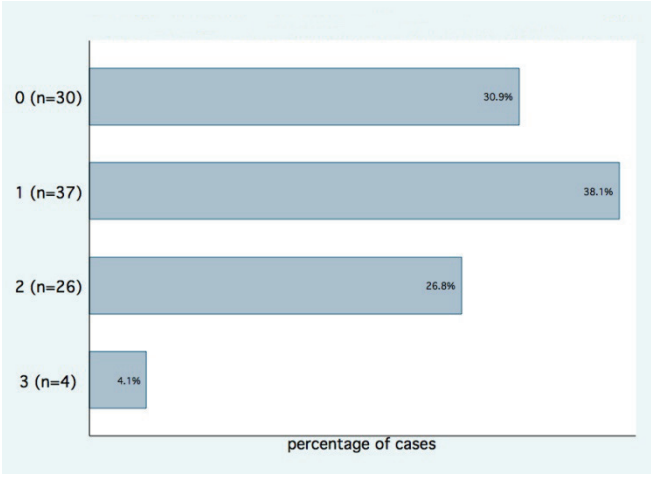

Figure 24: Number of Debtor Financial Advisors & Turnaround Consultants

181 The only other study of financial advisors in chapter 11 includes turnaround consultants among its definition of financial advisors. Lynn M. LoPucki & Joseph W. Doherty, *Rise of the Financial Advisors: An Empirical Study of the Division of Professional Fees in Large Bankruptcies*, 82 Am. Bankr. L. J. 141 (2008) [hereinafter, "LoPucki (2008)"].

182 Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. Pa. L. Rev. 1209, 1229 (2006).

A. Prevalence and Cost of Financial Advisors

As shown on Figure 24, almost 70% of the debtors, or 67 of 97 debtors, in the dataset retain at least one financial advisor or turnaround consultant, and an almost equal number retain more than one. Eleven debtors retained a turnaround consultant but no financial advisor.

In the dataset, 74 of the 97 cases have at least one committee. In 57 of these cases the committees retained at least one financial advisor.

Table 25 shows the relationship between retention of financial advisors by the debtor and its committees. Note that zero committee retentions on this table can either mean there was no committee, which happened in 22 cases, or the committee retained no financial advisors, which happened in 18 cases, yielding the 40 total cases seen on the Table. Other than no financial advisors or turnaround consultants in the case whatsoever, the next most likely outcome is for the debtor and committee to each retain one financial advisor or turnaround consultant, followed closely by one committee retention and two debtor retentions.

Table 25: Number of Financial Advisors & Turnaround Consultants

	Retained by committees in case			
Retained by debtor in case	*0*	*1*	*2*	*Total*
0	24	6	0	30
1	12	22	3	37
2	4	19	3	26
3	0	2	2	4
Total	*40*	*49*	*8*	*97*

In eleven cases there was more than one committee appointed. In all of these cases the committees retained at least one financial advisor, and in six cases they retained two – most often with each committee retaining its own financial advisor. Multiple retentions of financial advisors by debtors do not seem to turn on the number of committees. For example, there are 26 cases where the debtor retained two or more financial advisors in cases with but a single committee.

If we limit our focus to the first committee appointed in the case – typically the basic unsecured creditors committee – in 51 cases that committee retained a single financial advisor, in four cases it retained two financial advisors.

Financial advisors – including turnaround consultants – are less likely to be retained by debtors in the smallest quartile of cases in the dataset. As shown on Table 25A, it also appears that multiple retentions are less likely to occur with respect to the smaller debtors.[183]

183 Cases with no financial advisors are omitted from the table to reduce the number of cells and increase the readability. Tables 25 and 25A will not match up exactly, since Table 25A includes cases without committees, unlike Table 25.

Table 25A: Combined Debtor and Committee Financial Advisor and Turnaround Consultant Retentions, by Debtor Size

	Number retained in case						
Debtor size by quartile	*1*	*2*	*3*	*4*	*5*	*6*	*Total*
(smallest) 1	8	3	1	0	0	0	12
2	7	7	4	1	1	1	21
3	3	7	9	3	0	0	22
4	4	4	10	1	2	0	21
Total	22	21	24	5	3	1	76

Cases with no retentions omitted

Table 26 shows the typical cost for financial advisors and turnaround consultants. For the 66 cases with at least one financial advisor or turnaround consultant, the extra cost associated with these averages $2.9 million, with a median cost of $1.6 million.[184] The debtor spends much more on these professionals than committees, with the average debtor spending $2.5 million as compared with $862,000 for committees. In other words, debtors spend an average of about three times as much on these professionals as committees do.[185]

Table 26: Cost of Financial Advisors and Turnaround Consultants

	Obs	*Mean*	*Std. Dev.*	*Median*	*Min*	*Max*
Debtor FA	51	$1,966,577.00	$2,296,789.00	$1,406,436.00	$3,232.26	$10,400,000.00
Debtor TC	23	$2,113,132.00	$3,232,314.00	$1,010,300.00	$152,947.90	$15,800,000.00
Debtor Total	59	$2,523,684.00	$3,767,882.00	$1,512,281.00	$3,875.04	$24,500,000.00
Committee FA	53	$862,493.20	$868,316.80	$554,448.00	$4,025.00	$3,028,514.00
All combined	66	$2,948,628.00	$4,206,185.00	$1,615,799.00	$3,875.04	$26,900,000.00

As shown in the top graph in Figure 27, in cases with both turnaround consultants and financial advisors, these professionals constitute the biggest portion of overall cost save for debtor's counsel, although the small number of such cases suggests the need for caution. And as also shown on the same graph, these professionals combined with bankruptcy counsel for the debtor and committee make up more than 71% of the overall cost of such a case. Turnaround consultants account for 17.27% of total cost, while financial advisors account for 17.05% of total cost.

184 The number of retained professionals in the following tables are often somewhat less than the total number of retentions discussed earlier, because in some cases the fee applications were missing from the docket. That is, in some cases I know a financial advisor or turnaround consultant was retained, but I do not know how much they were paid.

185 Debtors spend 2.6 times as much on a median basis.

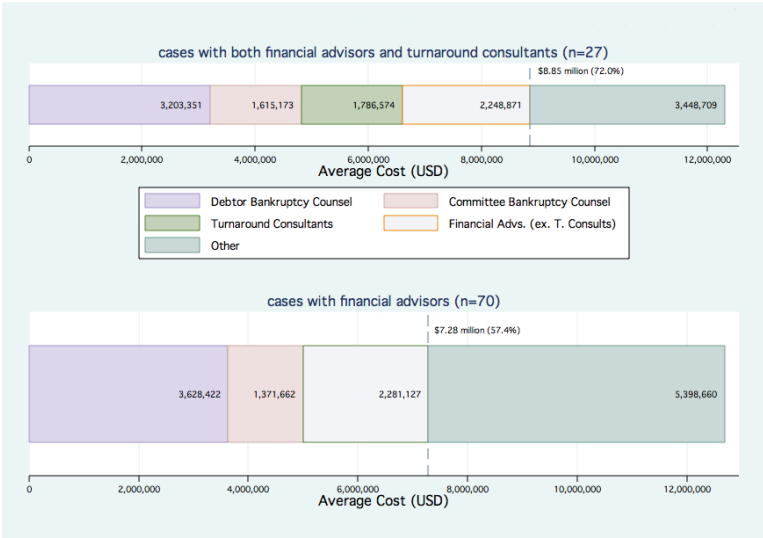

Figure 27: Components of Overall Chapter 11 Cost

The bottom graph in Figure 27 shows cases with financial advisors, whether or not there was a turnaround consultant. In this larger group, financial advisors account for 18.2% of average cost, and together with the attorneys these three groups of professionals represent almost 60% of the average total cost in the chapter 11 case. Financial advisors, although receiving much attention and criticism, actually cost slightly less, on average, than the debtor's bankruptcy attorneys.

The remaining 40% of professionals are comprised of a variety of lawyers, accountants, and other professionals. Some, like appraisers and real estate professionals, may be directly involved in the bankruptcy cases, while others may be exogenous to the bankruptcy process, like lawyers handling a specific piece of non-bankruptcy litigation or auditors that would have been retained even if there had never been a bankruptcy case. In the latter case, the professionals earn too much compensation to be retained under an OCP motion. Figure 28 shows the breakdown of these professionals. Attorneys retained under section 327(e) of the Code, that is, attorneys retained for a specific non-bankruptcy purpose, are the most common "other" professional.[186]

186 11 U.S.C. §327(e) ("The trustee, [and thus the debtor in possession] with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed."). This contrasts with the "normal" mode of retention, which is under section 327(a). 11 U.S.C. § 327(a) ("Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold

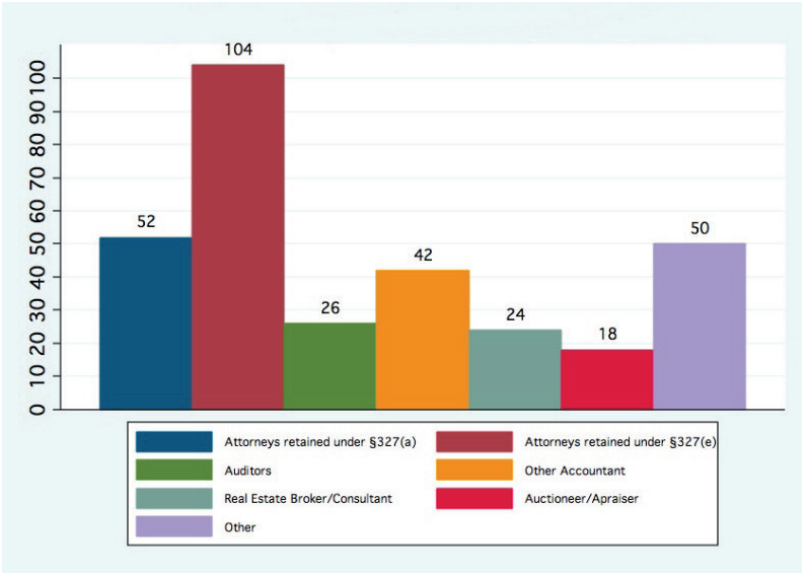

Figure 28: Frequencies of Other Professionals

B. Modeling the Cost of Financial Advisors

In the only other attempt to model financial advisors costs in chapter 11, LoPucki (2008) found that debtor size, filing in Delaware or New York, and the number of financial advisors retained in the case were the key factors ($p<0.05$) in predicting total financial advisor cost.[187] The authors also found that retention of KPMG LLP as a financial consultant reduced overall cost, although the implications of this finding are not discussed in the article.[188]

I begin by testing the LoPucki (2008) model on my data, using the same factors save for KPMG retention. In LoPucki (2008) all factors were positively related to total financial advisor cost, although time spent in chapter 11 was not significant. The authors report that Model II on Table 10 in LoPucki (2008) resulted in an adjusted R-squared of 0.68.

When applied to the present dataset, the LoPucki model achieves an adjusted R-squared (0.431). The two jurisdictional variables are not significant.

On Table 29 I develop my own model. In the first model I consider debtor size. This should be positively related to cost, but consistent with my prior stud-

or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.")

187 The authors also found that their "trend" variable was significant ($p < 0.01$).

188 http://us.kpmg.com/services/content.asp?l1id=10&l2id=760.

ies of other aspects of chapter 11 costs, I would expect debtor size to decrease in import as the models begin to address complexity and other factors more directly.

In the second model I add a proxy for complexity, namely a dummy variable that indicates whether a claims agent was used in the case.[189] This should be positively correlated with cost.

In the third model, I add a dummy variable that indicates if both the debtor and the committees had at least one financial advisor. This reflects the insight from Table 29.1, which shows that there is often a kind of parallelism between debtor and committee retention of financial advisors. This variable thus indicates whether this is a case where this kind of joint retention is present.

Table 29.1: Number of Financial Advisors Retained

	Committees		
Debtor	*None*	*1 or more*	*Total*
None	26	15	41
1 or more	14	42	56
Total	40	57	97

In the final model I add the number of fee objections in the case to this model, log transformed and mean centered – that is, the mean is subtracted from every value.[190] I use this variable as an index of how contentious the case is, theorizing that these cases might be more likely to result in valuation disputes and other litigation and challenges to the financial advisors' work. The large lump sum fees that financial advisors and turnaround consultants receive might make them the likely targets of a case with more fee objections. And financial advisors typically pass on the cost of defending their retention and compensation in the bankruptcy court, which means that a more contentious case will result in another layer of attorneys' fees paid through the financial advisors' fee applications. By mean-centering the variable, the coefficient can now be interpreted as indicating the extra cost associated with above average "contentiousness." Cases with less than average contentiousness will have a negative value in this variable, which, combined with the positive coefficient shown on Table 29, results in lower overall financial advisor costs.

As in the other chapters, throughout this chapter I adjust the standard errors to account for potential, unseen correlations among cases within the same judicial district (*i.e.,* clustered standard errors).

189 Ordinary course professional motions are not used in this chapter, inasmuch as the financial advisors and turnaround consultants, unlike attorneys, would not be much affected by such a motion.

190 Log of a zero value is undefined. To account for the number of cases with zero objections, I also add a constant (0.001) to the total number of objections in all cases.

Table 29: Models of Total Financial Advisor Cost

	(1) Log of total TC & FA cost in case	*(2)* Log of total TC & FA cost in case	*(3)* Log of total TC & FA cost in case	*(4)* Log of total TC & FA cost in case
Log of debtor size	0.501*	0.317	0.234	0.236
	(0.185)	(0.173)	(0.136)	(0.124)
Claims agent		0.776**	0.566**	0.478**
		(0.258)	(0.197)	(0.173)
Both retained FA			0.844***	0.789***
			(0.197)	(0.172)
Log case objs, centered				0.142***
				(0.0381)
Constant	1.855	2.895*	3.181**	3.179**
	(1.521)	(1.321)	(1.004)	(0.930)
Observations	66	66	66	66
R2	0.246	0.390*	0.567***	0.644***

Robust standard errors in parentheses; se adjusted for clustering by district; mean VIF (model 4) 1.21
* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

The final model explains 64.4% of the variance in total financial advisor and turnaround consultant costs, comparable to the models described in LoPucki (2008). The joint retention of financial advisors, case complexity, and the contentiousness of the case are all significant factors in the cost, after size and complexity are accounted for.

The first two models, which involve size and complexity, explain very little, which suggests most of the work is done by the variables added in the last two models.

C. The Debtors' Financial Advisors & Turnaround Consultants

As noted on Table 26, the bulk of the cost associated with financial advisors comes from the debtor's side of the case. Similarly, turnaround consultants are a debtor-only phenomenon. Accordingly, I use this section to explore an extension of the model developed on Table 29 to the specific issue of debtor financial advisors and turnaround consultants.

Table 30 shows that while turnaround consultants and financial advisors are often retained by the same debtor, the two are largely independent. In 12 cases there were turnaround consultants without financial advisors, and in 38 cases there were financial advisors without turnaround consultants, in 13 cases there were multiple financial advisors without any turnaround consultants. And in 29 cases the debtor retained neither.

Table 30: Number of Debtor Financial Advisors and Turnaround Consultants

	Financial Advisors				
Turnaround Consultants	*0*	*1*	*2*	*3*	*Total*
0	29	25	12	1	67
1	10	15	2	0	27
2	2	1	0	0	3
Total	41	41	14	1	97

I model debtor financial advisor cost (Model 1) and the combined cost of financial advisors and turnaround consultants (Model 2) on Table 31. In both cases I use a modified version of the final Model from Table 28, accounting for the change in dependent variables, which no longer includes committee financial advisors.

In particular, I enter measures of size, a proxy for complexity, and the measure of case contentiousness, the mean-centered number of fee objections in the case. I also use the dummy variable that indicates the retention of one or more turnaround consultants. In addition, in these models I use a variable that indicates if a committee was appointed in the case and another that counts the number of debtor financial advisors. I hypothesize that all variables should be positively related to cost in either model.

Table 31: Models of Debtor Fin. Advisor & Turnaround Consultant Cost

	(1)	*(2)*
	Log of Debtor FA cost	Log of Debtor TC & FA cost
Log of debtor size	0.435**	0.363***
	(0.142)	(0.0737)
Claims agent	0.119	0.169
	(0.217)	(0.150)
Number of debtor FAs	-0.102	-0.0252
	(0.176)	(0.131)
Turnaround consultant	0.0654	0.327*
	(0.250)	(0.157)
Log of objs, mean centered	0.143***	0.134***
	(0.0353)	(0.0352)
Committee	0.834*	0.670*
	(0.327)	(0.281)
Constant	1.540	2.139**
	(0.925)	(0.599)
Observations	49	57
R2	0.691	0.681

Robust standard errors in parentheses; se adjusted for clustering by district; mean VIF 1.48 and 1.27, respectively.

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

The first model considers the cost of debtor financial advisors alone. Size, case contentiousness (number of fee objections), and an appointment of a committee are the key factors in this model. Interestingly, the number of debtor financial advisors is not significant, suggesting that it does not matter if the work is divided among multiple financial advisors. The appointment of a turnaround consultant also is not significant, suggesting that the cost of financial advisors is somewhat independent from the appointment of these related professionals.

The second model follows the LoPucki (2008) approach and considers the two types of debtor professionals in the aggregate, using the same model. The turnaround advisor variable is now significant, which is to be expected as the difference in the two dependent variables is the turnaround consultant cost.

Interestingly, in both models size is significant again. This may suggest a debtor-specific effect that was hidden when considering the joint cost of financial advisors in Table 29. For example, there may be an unmodeled element of complexity here – larger debtors may engage their financial advisors in different ways than smaller debtors.

Summary

This chapter examines the other big source of professional costs in chapter 11: financial advisors, and the subsidiary group of professionals known as "turnaround consultants." Almost 70% of the debtors, or 67 of 97 debtors, in the dataset retain at least one financial advisor or turnaround consultant, and an almost equal number retain more than one. Many committees also retained financial advisors.

For the 66 cases with at least one financial advisor or turnaround consultant, the extra cost associated with these averages $2.9 million, with a median cost of $1.6 million. The debtor spends much more on these professionals than committees, with the average debtor spending $2.5 million as compared with $862,000 for committees. In other words, debtors are spending an average of about three times as much as committees on these professionals. Perhaps most importantly, this chapter shows that the joint retention of financial advisors by the debtor and the committee results in increased cost