ILENE J. LASHINSKY (#003073)
United States Trustee
District of Arizona

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IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF ARIZONA

In re: SKYMALL, LLC, Debtor. Joint Administration pending with: XHIBIT CORP., XHIBIT INTERACTIVE, LLC, FLYREPLY CORP., SHC PARENT CORP., SPYFIRE INTERACTIVE, LLC, STACKED DIGITAL, LLC, and SKYMALL INTERESTS, LLC.	In Proceedings Under Chapter 11 Case No. 2:15-bk-00679-BKM Joint Administration pending with Case Nos.: 2:15-bk-00680-MCW 2:15-bk-00682-MCW 2:15-bk-00684-DPC 2:15-bk-00685-MCW 2:15-bk-00686-MCW 2:15-bk-00687-GBN 2:15-bk-00680-EPB
This Pleading applies to: ☑ All Debtors ☐ Specified Debtors	**UNITED STATES TRUSTEE'S RESPONSE TO DEBTORS' BRIEF IN SUPPORT OF COHNREZNICK CAPITAL MARKET SECURITIES, LLC'S EMPLOYMENT APPLICATION** **Hearing Date: February 19, 2015** **Hearing Time: 1:30 p.m.**

The United States Trustee for the District of Arizona, Ilene J. Lashinsky (the "**U.S. Trustee**"), hereby files her response to the above captioned debtors' ("**Debtors**") *Brief in*

Support of CohnReznick Capital Market Securities, LLC's Employment Application (the "**Support Brief**") filed on February 2, 2015, at Court's docket entry number ("D.E. No.") **62**.

This matter first came before the Court pursuant to the Debtors' *Emergency Application for Entry of an Order Authorizing the Employment and Retention of CohnReznick Capital Market Securities, LLC as Investment Banker Pursuant to 11 U.S.C. §§327 and 328* (the "**Application**") [D.E. No. **21**] as part of their first day motions heard on January 27, 2015 at 1:30 p.m. ("**First Day Motions Hearing**"). The Application was and is supported by: (i) the *Verified Statement in Support of Debtors' Emergency Application for Entry of an Order Authorizing the Employment and Retention of CohnReznick Capital Market Securities, LLC as Investment Banker Pursuant to 11 U.S.C. §§327 and 328* (the "**Manning Statement**"), attached as Exhibit A to the Application; and (ii) the *Declaration of Scott Wiley in Support of First Day Motions* (the "**Wiley Declaration**") [D.E. No. **8**].

In her *Omnibus Response to First Day Motions* ("the **Omnibus Response**") [D.E. No. **27**], the U.S. Trustee objected to the Application on two grounds:

- The Application sought to improperly restrict the Court's review of CohnReznick Capital Market Securities, LLC ("**CRCMS**") proposed fees and costs subject to the 11 U.S.C. § 328 improvident standard; and

- The Application contains an indemnification clause that is inappropriate under the facts of this case and is disfavored overall by the Ninth Circuit Court of Appeals ("**Ninth Circuit**").

This Court sustained the U.S. Trustee's objections on an interim basis and granted the employment of CRCMS during the interim period with the following limitations:

- Interim employment is subject to the reasonableness standard of 11 U.S.C. § 330 rather than the requested 11 U.S.C. § 328 improvident standard; and

- denying any indemnification during the interim period.

The Court then set a final hearing on the Application for February 19, 2015. The Court requested that the Debtors and the U.S. Trustee submit additional briefs regarding the issues of indemnification and the application of the 11 U.S.C. § 328 improvident standard in this case for CRCMS.

Through the proper application of applicable precedent stemming from within the Ninth Circuit to the facts of this case, one can clearly conclude that both the requested indemnification provision and use of the 11 U.S.C. § 328 improvident standard in this Application are inappropriate and should be denied.

I. THE REQUESTED INDEMNIFICATION PROVISION MUST BE DENIED

As detailed in the Omnibus Response, the seminal decisions in the Ninth Circuit tell us that "injunctions," "releases," and "indemnifications" of insiders and professionals are generally disfavored. *See* Resorts Intl., Inc. v. Lowenschuss, (In re Lowenschuss), 67 F. 3d 1394, 1402 (9th Cir. 1995); In re American Hardwoods, 885 F.2d 621, 626 (9th Cir. 1989); Underhill V. Royal, 769 F.2d 1426, 1432 (9th Cir. 1985) Bankruptcy courts have taken great pains to ensure they do not exceed the bounds established by *Lowenchuss, American Hardwood,* and *Underhill* (the "Ninth Circuit Standard").

It is with this back drop of the Ninth Circuit Standard that, ***in the only published decisions in the Ninth Circuit***, bankruptcy courts have concluded exculpation and indemnification provisions in employment agreements that limit liability for negligence, breaches of fiduciary duties and other actions must be reasonable. Further, the burden is on the proponent of the application to establish that it is reasonable for the estate to be exposed to any risk at all. See In re Metricom, Inc., 275 B.R. 364, 371 (Bankr. N.D. Cal. 2002) (holding broad indemnification and exculpation provision of financial advisor agreement not approved, based on no showing of reasonableness, but such provisions not invalid *per se*); see also, In re Mortgage & Realty Trust, 123 B.R. 626, 631 (Bankr. C.D. Cal. 1991) (holding investment advisor agreement providing for indemnification extending only to acts other than negligence, gross negligence, or willful misconduct found not to be reasonable).

In Metricom the bankruptcy court agreed with the U.S. Trustee that as a general proposition, the majority view is that indemnification and exculpation provisions for professionals are disfavored. See Metricom, 275 B.R. at 371. In light of the fact that professionals are employed pursuant to 11 U.S.C.§ 327, the court must determine whether the terms and conditions of the employment are *reasonable* in the context of this case. Id. at 369. Further, pursuant to 11 U.S.C.§ 328(a) the burden is on the proponent of the application to establish that it is reasonable for the estate to be exposed to any risk at all. Id. at 374 - 375.

The professional in Metricom was seeking an indemnification provision that included any act or omission excluding gross negligence or willful misconduct. In

determining the reasonableness of the requested indemnification, the Metricom bankruptcy court eschewed the factors applied by In re Joan and David Halpern, Inc., 248 B.R. 43 (Bankr.S.D.N.Y.2000) and instead inquired as to:[1]

- What steps has the professional sought protection for its acts or omissions in the case from a source other than the estate (e.g. malpractice, errors and omissions insurance, etc.)?

- What efforts were made by the debtor to seek comparable services for the same price without having to agree to these provisions?

- What evidence exists that the professional would not provide the services without the provision?

Metricom, 275 B.R. at 371-373.

The professional in Metricom could not adequately address any of the Court's points of inquiry and thus their request for indemnification was found to be unreasonable.

In the instant case, the Debtors are seeking an indemnification on behalf of CRCMS that precludes any liability for their acts or omissions short of gross negligence, bad faith or willful misconduct. The Debtors support their position by imposing factors applied by bankruptcy courts in unreported decisions and as identified in Halpern. As noted by the courts in both Metricom and Mortgage & Realty, "Unreported bankruptcy court decisions have very little weight as precedent. When a bankruptcy judge wants a decision to serve as precedent, the judge publishes the decision. Unpublished decisions do not establish case law and do not serve as precedent." Mortgage & Realty, 123 B.R. at 630, see also, Metricom, 275 B.R. at 370. Further, the one published decision that the

[1] The Metricom court did indicate that, if applicable, the court would take into consideration as a non-determinative factor, whether evidence existed that the marketplace strictly imposed terms such as those requested by the professional. See Metricom 275 B.R. 373, n.13.

Debtors use to support their position, Halpern, the bankruptcy court in Metricom declined to follow.

CRCMS has not provided any indication as to whether it first sought protection from its acts or omissions in this case from sources other than the bankruptcy estate. It is commonplace for investment banking firms to purchase errors and omissions coverage – even for specific transactions. The Debtors have provided no evidence as to whether they sought services from other firms that would not require such an indemnification. Only last month in a case with facts almost exactly as in this case (In re SNTech, Inc., Case No., 2:14-bk-17914-EPB), the Gordian Group, LLC, with Peter Kaufman as the managing director agreed to waive a indemnification provision to represent the debtor as the investment banker. There is no evidence on the record that CRCMS will not accept employment in this case without the indemnification provision. Finally, the SNTech case clearly demonstrates that the market for investment banking services does not mandate such indemnity provisions.

Further, in Mortgage & Realty Trust the bankruptcy court rejected Dean Witter's request for indemnification for acts other than negligence, gross negligence or willful misconduct as unreasonable. In its determination the court focused on the following facts which are also applicable in the instant case:

- No other professionals (attorneys and accountants) had requested such indemnity in the case and were prohibited from doing so by applicable ethics rules. See Mortgage & Realty, 123 B.R. at 629-630.

- Investment advisors are fiduciaries who owe a duty of fidelity, undivided loyalty and impartial service in the interest of their clients, as such it was

improper to indemnify them for negligence and breach of fiduciary duty. See Id. at 630, citing In re Allegheny International, Inc., 100 B.R. 244, 246-247 (Bankr.W.D.Pa.1989).

- Debtor has offered no evidence of its reasonableness. The reason for hiring a professional person is that the person has the special expertise that such 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. Indemnification is not consistent with professionalism. Mortgage & Realty, 123 B.R. at 630-631.

- There is nothing in the Bankruptcy Code that requires a bankruptcy court to consider the usual terms of employment of a professional outside of bankruptcy. Id. at 631.

- Whether the debtor's estate should indemnify a professional for a claim against the professional arising out of the case should be determined by the bankruptcy court after the facts giving rise to the claim are known. Whether indemnification should be offered to a professional should be determined on a case by case basis, after the claim has been asserted for which indemnity is sought. Id.

- Any argument based upon a professional's unwillingness to accept employment without an indemnity agreement is not a legitimate ground for authorizing an indemnity provision. Id.

- Any argument that the indemnity provision requested is no greater than that allowed by applicable state law is of no moment. If the indemnity provision that is proposed is the same as what the common law provides, the Court does not need to approve it: It is an idle act for the Court to grant rights that already exist absent a court order. Id. at 631-632.

This entire case rests on CRCMS to properly perform its duties and responsibilities. CRCMS has advised the Debtors on how to sell its assets, it is marketing the Debtors' assets for sale, it will be negotiating the deal points with potential purchasers

on behalf of the Debtor, and at CRCMS' own request – it will be conducting the auction to sell those assets versus having the Court conduct the auction. Finally, CRCMS will have significant influence on the selection of which offer(s) qualify as the "highest and best" for presentation to this Court at the final sale hearing. That is a vast amount of influence and control over the administration of this bankruptcy estate. Yet, CRCMS would have the estate bear the risk if it acts negligently or breaches its fiduciary duty to the estate?

Based upon the foregoing, the U.S. Trustee submits that the Debtors and CRCMS have failed to meet their burden in establishing that it is reasonable for the estate to be exposed to any risk at all. As such, the request for the indemnification provision must be denied.

II. CRCMS' FEES SHOULD BE REVIEWED PURSUANT TO 11 U.S.C. § 330'S REASONABLENESS STANDARD

The Ninth Circuit has specifically held that the bankruptcy court may condition the employment of a professional with their compensation being subject to a reasonableness review under 11 U.S.C. § 330, despite whether the employment application is originally made requesting a compensation structure that includes flat fees and fees based upon percentages pursuant to the improvident standard of 11 U.S.C. § 328,. See In re B.U.M. Int'l, Inc, 229 F.3d 824, 829 (9th Cir. 2000).

In B.U.M. Int'l, Inc. the debtor's financial and strategic consultant filed an employment application pursuant to 11 U.S.C. § 328 requesting both a monthly flat fee of $7,500.00 and certain contingency fees based percentages of (i) post-petition financing,

(ii) the fair market value from sale of assets, and (iii) the fair market value of capital raised. The U.S. Trustee objected to the proposed compensation structure absent a clear statement that the bankruptcy court had the discretion to determine whether the fees were reasonable and a benefit to the bankruptcy estate. The bankruptcy court subsequently entered an order approving the employment application with the proviso that "all fees and costs of [the consultant] are subject to Court approval." Id. at 826.

Subsequently thereafter, the debtor's attempts at a reorganization failed and the Unsecured Creditors Committee successfully confirmed its plan of reorganization. Upon confirmation of the Committee's plan, the debtor's consultant filed its fee application seeking approval of the accrued monthly fees and contingency fees in an amount of approximately $900,000.00. The bankruptcy court conducted an 11 U.S.C. § 330 inquiry and approved the flat monthly fees, but denied the $900,000.00 in contingency fees in their entirety determining that the consultant's services had not benefitted the estate. Id. at 827.

The consultant eventually appealed the matter to the Ninth Circuit arguing that because the employment application was made pursuant to 11 U.S.C. § 328, the bankruptcy court was prohibited from applying a reasonableness review pursuant to 11 U.S.C. § 330. The Ninth Circuit agreed that "[T]here is no question that a bankruptcy court may not conduct a § 330 inquiry into the reasonableness of the fees and their benefit to the estate if the court already has approved the professional's employment under 11 U.S.C. § 328. Id. at 829, citing, Pitrat v. Reimers (In re Reimers), 972 F.2d 1127, 1128 (9th Cir.1992)."

However, the Ninth Circuit went on to find that the bankruptcy court had not unconditionally approved [the consultant's] employment application under § 328. "To the contrary, [the bankruptcy court] specifically reserved the right to approve the fees. Even if the bankruptcy judge thought that such a reservation was unnecessary to keep the door open for court approval of the fees and costs, he nevertheless specifically and in writing put all interested parties on notice that all of [the consultant's] fees were subject to court approval down the road." Id.

The Ninth Circuit provided a recommendation for future bankruptcy courts in regard to these cases:

> Although in this case the record clearly indicates that the employment agreement was *not* unconditionally approved under § 328, for future reference, we point out that the better practice would be for a bankruptcy court to accept or reject a proposed employment agreement, not to conditionally accept it subject to later review. That way, professionals would know exactly where they stood before undertaking the engagement.

Id. at 830.

The instant case, like that of B.U.M. Int'l, Inc., carries a multitude of potential pitfalls that may be unforeseen. In one case currently in the District of Arizona, the debtor sold substantially all of its assets pursuant to an expedited sale hearing conducted by the debtor without direct court oversight. Following the closing of the sale significant litigation ensued. Additional litigation continues to ensue over the purchase of assets that at this point threatens confirmation of the liquidating plan.

Pursuant to the terms of the sale procedures approved by this Court, CRCMS will be responsible for conducting the auction of the estate's assets, negotiating the purchase

price of the assets, and recommending to the Court the highest and best offer(s) for the Court's approval. Under the terms of the Application and related engagement letter, CRCMS will be paid on its percentage fees directly out of escrow from the sale of the Debtors' assets.

In the event the Application is approved subject to the improvident standard pursuant to 11 U.S.C. § 328, the Court will not be able to adjust CRCMS' fees if events occur after the sale closing that expose the estate to litigation or other events that lead to diminished returns from the sale. Thus, the U.S. Trustee urges the Court to specifically condition the employment of CRCMS subject to the reasonableness standard of 11 U.S.C. § 330 so that if something goes wrong with the purchase agreement(s) or issues arise regarding the sale process after closing, the Court retains the discretion to adjust CRCMS' compensation in relation to the benefit that its services truly confers upon the bankruptcy estate.

RESPECTFULLY SUBMITTED this 13th day of February, 2015.

ILENE J. LASHINSKY
United States Trustee
District of Arizona

/s/ Larry L. Watson
LARRY L.WATSON
Trial Attorney