

Emerging Bankruptcy Roles for Turnaround Consultants

BY GARRY M. GRABER, PARTNER, & MAUREEN T. BASS, SENIOR ASSOCIATE, HODGSON RUSS LLP

Turnaround consultants are watching emerging trends as the industry prepares for an increase in bankruptcies. This article discusses nontraditional roles being played by turnaround consultants.

Prior to enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), patients of bankrupt health care businesses had little voice in the proceedings. To protect those patients, Section 333 of the U.S. Bankruptcy Code now requires that the Office of the U.S. Trustee appoint a “disinterested” patient care ombudsman for every “health care business” in Chapters 7, 9, and 11, unless the court finds appointment unnecessary “for the protection of patients under the specific facts of the case.”

The consultant is charged with monitoring and reporting on the quality of patient care. If the consultant finds that care declines significantly or is materially compromised during the case, the individual is to file a report or motion with the court immediately.

In 2007, there were at least 271 cases in which the appointment of patient care ombudsmen was an issue. The cases involved nursing homes, hospitals, sole practitioners, partnerships, clinics, nursing services, home health services, and other health-related entities. Several reported decisions addressed efforts to avoid the appointment based on the assertion that the debtor was not a “health care business.”¹

Courts have used a four-prong analysis to narrow that issue, considering whether:

1. The debtor was a private or public entity
2. The debtor primarily engaged in offering to the general public facilities and services
3. The facilities and services were for the diagnosis or treatment of injury, deformation, or disease
4. The facilities and services were for surgical care, drug treatment, psychiatric care, or obstetric care²

Other arguments used in attempts to avoid a healthcare business classification included assertions that the debtor had no malpractice claims, that insurance companies were acting as “virtual ombudsmen,” and that the debtor’s practice was outpatient-based. One position that has garnered particular attention is that the estate cannot afford an ombudsman.³ Like other turnaround professionals, ombudsmen are paid by the debtor after notice and bankruptcy court approval.

Until this area of law is more settled, turnaround consultants should tread carefully when taking on the role of the health care ombudsman.

One emerging issue is whether an ombudsman can retain professionals. Although the code does not expressly provide for such, courts have approved them, but not uniformly. In *Julian Ungar-Sargon*, the court denied the ombudsman’s initial request to employ attorneys based on the fact that the code does not provide for such relief.⁴ In *Bayonne Medical Center*, both the debtor and the creditors’ committee objected to an ombudsman’s request to employ a medical operations advisor and counsel, asserting duplication and cost.⁵ The U.S. Trustee appears to have taken the position that such professionals may only be retained upon an affirmative showing of need.

An ombudsman’s desire for counsel and other professional expertise is to be expected because the code does not provide for immunity or exculpation for asserted liability, including claims related to the complex compliance requirements of the Health Insurance Portability and Accountability Act of 1996 (HIPAA). Ombudsmen have requested exculpations and/or releases in motions for termination of their duties.⁶ Many requests for blanket immunity have been denied.

In *Beth Israel Hospital Association of Passaic*, the ombudsman requested an order exculpating himself and his agents “from any liability arising out of or in connection with service in the capacity” of patient care ombudsman.⁷ The court ruled that the “Ombudsman Parties are not protected by immunity, whether quasi-judicial immunity, testimonial immunity or any other form of immunity arising from or relating in any way to the performance of the duties of the Ombudsman in the Debtor’s Chapter 11 proceeding, including reports, pleadings or other writings filed by the Ombudsman.” Until this area of law is more settled, turnaround consultants should tread carefully when taking on the role of the health care ombudsman.

BAPCPA also added code Section 332, which requires the appointment of a consumer privacy ombudsman when a debtor with a privacy policy intends to sell or lease customer information. The consultant assists the court in considering the sale or lease of personally identifiable information by filing a report that includes information concerning the debtor’s privacy policy, the potential losses or gains of privacy to consumers if the court approves a sale or lease, the potential costs or benefits to consumers, and potential alternatives that would mitigate potential privacy losses or costs to consumers. Section 332 prohibits the ombudsman’s disclosure of any privacy information he or she acquires.

Although there are few reported decisions under Section 332, many of the issues affecting health care ombudsmen are likely to affect the consumer privacy ombudsman as well.⁸

A ‘Responsible Person’

A basic tenet of Chapter 11 is that absent extraordinary circumstances management remains “in possession” of and operates the business and, with a few exceptions, has the powers and duties of a trustee. Occasionally, however,

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management is unable or unwilling to navigate through Chapter 11 and in an attempt to avoid the expense and uncertainty of a trustee an effort is made to appoint a turnaround consultant to act as the debtor's "responsible party."⁹


In *Gaslight Club, Inc.*, the Bankruptcy Court approved the appointment of a responsible person for some related companies. Upon filing, the president and majority shareholder retained control of the debtors. During the course of the bankruptcies, all parties consented to the appointment of an individual as a responsible person to run the debtors. The decision was later challenged but upheld, with the court relying on the earlier consent of the parties and Bankruptcy Code Sections 105 and 1107.¹⁰

In *The 1031 Tax Group, LLC*, the Bankruptcy Court refused to grant the U.S. Trustee's request for the appointment of a Chapter 11 trustee to replace new management (the new "responsible persons").¹¹ There, the court concluded that "new management" was not tainted by any misconduct of "old management" and, together with other factors, including the possibility of delay, new management would remain as responsible persons.

In *Adelphia Comm. Corp.*,¹² the Bankruptcy Court rejected a request for the appointment of a nontrustee fiduciary, finding no basis for such relief in the code. This issue seems to be arising more frequently because the appointment of a Chapter 11 trustee versus a responsible person has been argued in several cases with very different fact patterns, including *In re: Real Estate Partners,*

Inc.,¹³ *In re: National Consumer Mortgage*,¹⁴ and *In re: Branford Partners LLC*.¹⁵

Motions seeking the appointment of a responsible person typically invoke code Section 105, Bankruptcy Rule 9001, and the bankruptcy court's general equitable powers. Section 105, however, specifically prohibits appointment of a receiver, while Section 1104 contains specific authorization for the appointment of a Chapter 11 trustee. Thus, it is argued, the only operating fiduciary permitted are traditional managers who have the fiduciary duties of officers and directors or a Chapter 11 trustee.

Existing authority indicates that if a consultant is interested in serving as a responsible person in Chapter 11, he or she should seek to establish his or her role before filing, as the proposed appointment is likely to be contested. 

¹ Characterization as a health care business is significant, as the appointment of an ombudsman is not the only consequence. Other resulting issues include the proper disposal of patient records, the transfer of patients, and additional administrative expense. *In re: 7-Hills Radiology LLC* 350 B.R. 902 (Bankr. D. Nev. 2006).

² *In re: Medical Associates of Pinellas LLC*, 360 B.R. 356 (Bankr. M.D. Fla. 2007). In *Pinellas*, the debtor primarily provided administrative support services to doctors. The court concluded that it was not a health care business, as it did not offer its services to the public.

³ See, for example, *The Bertrand Chaffee Hospital*, Case No. 07-470 (W.D.N.Y. 2007) and *In re: Curative Health Services*, Case No. 06-10552 (S.D.N.Y. 2006).

⁴ *In re: Julian Ungar-Sargon*, Case No. 06-08108, (N.D. Ill. 2006). The Bankruptcy Court allowed the ombudsman to further brief the issue, and the ombudsman ultimately withdrew the request to appoint counsel.

⁵ *In re: Bayonne Medical Center*, Case No. 07-15195 (Bankr. N.J. 2007).

⁶ *In re: Upland Surgical Institute*, Case No. 06-11298, (Bankr. C.D. Cal. 2006).

⁷ *In re: Beth Israel Hospital Association of Passaic, d/b/a/ PBI Regional Medical Center*, Case No. 06-16186, (Bankr. D. N.J. 2006).

⁸ A sampling of cases dealing with consumer privacy ombudsman issues include: *In re: Refco Inc., et al.*, Case No. 05-60006 (Bankr. S.D.N.Y. 2007); *In re Storehouse, Inc.*, Case No. 05-11144 (Bankr. E.D. Va. 2006); *In re: Tweeter Home Entertainment Group, et al.*, Case No. 07-10787 (Bankr. D. Del. 2007); and *In re: Foxtons Inc.*, Case No. 07-24496 (Bankr. D. N.J. 2007).

⁹ A recent article authored by a member of the Office of the U.S. Trustee concludes that the appointment of a responsible party is not provided for in the Bankruptcy Code under any circumstances. See "Who's Responsible Here? 'Responsible Persons' in Chapter 11 Cases," Walter W. Theus, Executive Office for U.S. Trustees, *ABI Journal*, May 2008.

¹⁰ 782 F2d 767 (7th Cir.1986)

¹¹ 374 B.R. 78 (S.D.N.Y. 2007).

¹² 336 B.R. 610 (Bankr. S.D.N.Y. 2006).

¹³ Case No. 07-1440 (Bankr. C.D. Cal 2007).

¹⁴ Case No. 06-10429 (Bankr. C.D. Cal 2006).

¹⁵ Case No. 06-12551 (C.D. Cal 2006).

Garry M. Graber (top photo) is a partner in the law firm of Hodgson Russ LLP and heads the bankruptcy and restructuring practice. He is a past president of the TMA's Upstate New York Chapter and is also an adjunct professor at the University at Buffalo School of Law, where he teaches Chapter 11 reorganizations. Maureen T. Bass (bottom photo) is a senior associate in the bankruptcy and restructuring practice.



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