Viewpoint

One of a series of opinion columns by bankruptcy professionals

Beware Of Consultants Bearing Unlicensed Bankers

By Jeffrey R. Manning and Jeffrey T. Varsalone

Would you fly with an unlicensed pilot? Our guess is that even if you were reasonably confident that the unlicensed pilot was seasoned, experienced and competent, most of us would opt for the pilot certified with an up-to-date regulatory blessing that comes from a rigorous and formal qualification process, as evidenced by a license from the U.S. government.

However, throughout the corporate recovery world, attorneys and advisers frequently push work to unlicensed parties for a "quickie" sales process, and regulators are finally starting to focus on this practice. Through the authority of the U.S. Security and Exchange Commission, the independent self-regulating Financial Industry Regulatory Authority, or Finra, recently issued new rules governing the activities of consultants and financial advisers regarding conducting sales under Section 363 of the U.S. Bankruptcy Code, and these new rules are steadily creeping into various jurisdictions in bankruptcy courts across the nation. This new regulation may materially change to role turnaround professionals, with new and important distinctions emerging between interim managers, financial advisers, and investment bankers—with the latter focusing on capital markets and the sales process.

Consider that amid the evolving landscape of Chapter 11 "reorganizations," over the past two decades restructuring professionals have steadily watched the rise in 363 sales to the point where these sales vastly outnumber the traditional plan of reorganization. These days, an expedited sale process might consist of merely a few weeks from the commencement of the Chapter 11 case before the looming bid deadline, and with a little luck, perhaps an auction. Too often these quickie sales have insiders backing the abbreviated marketing effort run by unlicensed consultants.

If the debtor had foresight, sufficient liquidity and the luxury of time before the commencement of the Chapter 11 bankruptcy case, a reputable, professional and licensed investment banker should have spent several months before the filing looking for potential financial and strategic investors for either a recapitalization or an asset sale. This work is an excellent "missionary" activity to prepare for a market test in the event of a formal filing, and often a fulsome marketing process will uncover a solution that keeps the company out of bankruptcy altogether.

All too often, however, the debtor lacks the luxury of time, liquidity or foresight. Embarking on a post-filing marketing process is a significant challenge without the benefit of an investment bank. Often, especially in smaller cases, turnaround consultants or financial advisers attempt to create at least the appearance of a marketing process. In such case, these consultants and debtor should beware of these new Finra rules regarding financial advisers engaging in investment banking activities.

Registration And Licensing Requirements

Two specific Finra rules cut to the heart of these changes: Rule 1031(a) and Rule 1032(i). Rule 1031(a) requires that all persons engaged in investment banking activities be registered with Finra, which means passing a Qualification Examination. Rule 1032(i) sets forth the categories of representatives, the broadest being a General Securities Representative (Series 7). Finra has been troubled by the unlicensed investment banker for some time now, both inside and out of the corporate recovery profession, and after several years of study and comments, on April 13, 2009, the SEC approved a new subsection to this rule. Rule 1032(i) created a limited representative category for persons engaging in investment banking activities with its concomitant qualification process to mint the new Limited Representative Investment Banking Qualification Examination (the new Series 79). The rule explicitly states that each person involved in "*advising on or facilitating...financial restructurings, asset sales, divestitures or other corporate reorganizations or business combination transactions, including but not limited to rendering a fairness, solvency or similar opinion,*" must have this Finra license.

Accordingly, any financial adviser conducting an asset sale pursuant to Section 363 of the Code is clearly engaging in investment banking activities and is therefore subject to the registration and licensing requirements of Finra Rules 1031 and 1032. In addition, if a financial adviser is advising a debtor in connection with a plan of reorganization, depending on the nature of that advice, that advisor may also be subject to Finra Rules 1031 and 1032. Moreover, if the financial adviser is issuing an expert report on solvency, that adviser is probably subject to Finra Rules 1031 and 1032. Clearly, if the adviser rendering such services is holding itself out as an investment banker, Rule 1032(i) requires such adviser hold a Series 79 license.

Sanctions

According to Finra's Sanction Guidelines, persons who are not properly registered are subject to monetary sanctions ranging between $5,000 and $50,000 for each individual offender, the supervisory principals and the firm, plus the

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potential increase the fine to include the financial benefit received by the respondents. Additionally, the firm can be suspended with respect to certain activities for up to two years, and the supervisory principal can be suspended in any or all capacities for up to two years. In determining the appropriate sanction, Finra considers the nature and extent of the disqualified person's activities and responsibilities, whether a requisite examination application was pending and whether the disqualification resulted from financial and/or securities misconduct. In particularly egregious cases, such as a supervisory principal knowingly allowing a disqualified person to become associated with the firm, the individual and supervisory principal can be barred.

A Matter For The U.S. Trustee?

Thus far, we have seen limited instances of the Office of the United States Trustee becoming active in policing the licensing requirements of investment bankers in bankruptcy cases. We anticipate that the trend to ensure professionals are licensed and authorized to conduct such activities will continue to grow, as it is becoming more routine for the Office of the U.S. Trustee to retain Section 330 review of the fee applications for investment banking activities. Section 330 of the Bankruptcy Code contains a provision for the determination of "reasonable compensation" for services rendered based on a series of relevant factors, including "with respect to a professional person, whether the person is board certified or otherwise has demonstrated skill and experience in the bankruptcy field." Whereas Finra Rule 1031 requires an investment banker facilitating an asset sale or otherwise providing investment banking services in bankruptcy to be registered with Finra, perhaps U.S. Trustees will increasingly object to the amount of the fee requests of unlicensed investment bankers based on reasonableness? Such objections could be quite effective in policing unlicensed investment bankers in bankruptcy cases, as it would hit the offender where it hurts the most...in the wallet. Imagine how compliance with 1032 will improve the first time a bankruptcy judge disallows fees for an unlicensed investment banker.

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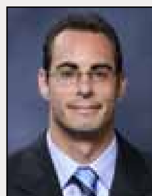

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