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IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE	§	
	§	**CASE NO. 12-31549-bjh-11**
CANO PETROLEUM, INC., ET AL.	§	**JOINTLY ADMINISTERED**
	§	
Debtors.	§	**(CHAPTER 11)**

APPLICATION TO EMPLOY AND RETAIN JAMES R. LATIMER, III AND BLACKHILL PARTNERS, LLC AS CHIEF RESTRUCTURING OFFICER

A HEARING WILL BE CONDUCTED ON THIS MATTER ON APRIL 17, 2012 AT 3:15 PM IN COURTROOM 14, UNITED STATES COURTHOUSE, 1100 COMMERCE STREET, DALLAS, TEXAS 75242.

IF YOU OBJECT TO THE RELIEF REQUESTED, YOU MUST RESPOND IN WRITING, SPECIFICALLY ANSWERING EACH PARAGRAPH OF THIS PLEADING. UNLESS OTHERWISE DIRECTED BY THE COURT, YOU MUST FILE YOUR RESPONSE WITH THE CLERK OF THE BANKRUPTCY COURT WITHIN TWENTY-THREE (23) DAYS FROM THE DATE YOU WERE SERVED WITH THIS PLEADING. YOU MUST SERVE A COPY OF YOUR RESPONSE ON THE PERSON WHO SENT YOU THE NOTICE; OTHERWISE, THE COURT MAY TREAT THE PLEADING AS UNOPPOSED AND GRANT THE RELIEF REQUESTED.

TO THE HONORABLE BARBARA J. HOUSER,
UNITED STATES BANKRUPTCY JUDGE:

Cano Petroleum, Inc., ("Cano") its direct and indirect subsidiaries (collectively, the "Company"), as debtors and debtors-in-possession (the "Debtors")[1] file this *Application to Employ and Retain James R. Latimer, III and Blackhill Partners, LLC as Chief Restructuring Officer* (the "Application"). In support of this Application, the Debtors incorporate (a) the *Declaration of James R. Latimer, III in Support of Voluntary Petitions, First-Day Motions and Designation as Complex Bankruptcy Case* (the "First Day Declaration"); and (b) the *Declaration in Support of Application to Employ and Retain James R. Latimer, III and Blackhill Partners, LLC as Chief Restructuring Officer* (the "Blackhill Declaration"), attached as **Exhibit A.**

Jurisdiction and Procedural Background

1. This Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 1334 and 157. This matter is a core proceeding pursuant to 28 U.S.C. § 157.

2. Venue is proper in this district pursuant to 28 U.S.C. §§ 1408 and 1409.

3. The statutory predicate for relief requested in this Motion is 11 U.S.C. §§ 105(a), 327, 363, and 1107 as complemented by Rule 2014 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"), and the Local Rules of this Court.

4. On March 7-8, 2012 (March 7, 2012 being the "Petition Date"), the Debtors each filed a voluntary petition for relief under Chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code"), thereby commencing these chapter 11 cases (collectively, the "Cases" or the "Case").

5. Since the Petition Date, the Debtors have continued to operate and manage their businesses as debtors-in-possession pursuant to Bankruptcy Code §§ 1107 and 1108.

[1] The Debtors include Cano Petroleum, Inc., Cano Petro of New Mexico, Ladder Companies, Inc., Square One Energy, Inc., Tri-Flow, Inc., W.O. Energy of Nevada, Inc., W.O. Operating Company, Ltd., W.O. Production Company, Ltd., and WO Energy, Inc.

6. The Office of the United States Trustee (the "U.S. Trustee") has not appointed an official committee of unsecured creditors in this Case.

Factual Background

A. The Debtors and their Business

7. The Debtors operate in the oil and natural gas industry and their business strategy historically has included developing and acquiring interests in mature oil fields with established primary and/or secondary reserves that may possess significant remaining upside exploitation potential by implementing various secondary and/or tertiary enhanced oil recovery techniques.

8. The Debtors have been in business for approximately eight years. Cano initially started as Huron Ventures, Inc. ("Huron"). After Huron merged with Davenport Field Unit Inc. and other entities in May of 2004, Huron changed its name to Cano.

9. Cano is the parent company to (a) Cano Petro of New Mexico ("Cano New Mexico"), a Texas corporation; (b) Ladder Companies, Inc. ("Ladder"), a Delaware corporation; (c) Square One Energy, Inc. ("Square One"), a Texas corporation; (d) Tri-Flow, Inc. ("Tri-Flow"), an Oklahoma corporation; (e) W.O. Energy of Nevada, Inc. ("W.O. Nevada"), a Nevada corporation; (f) WO Energy, Inc. ("WO Energy"), a Texas corporation; (g) W.O. Operating Company, Ltd. ("W.O. Operating"), a Texas limited partnership; and (h) W.O. Production Company, Ltd. ("W.O. Production"), a Texas limited partnership.

10. Cano is a publicly-traded company incorporated in Delaware and its common stock was listed on the NYSE Amex under the trading symbol "CFW."

11. As of January 17, 2012, Cano voluntarily delisted its stock and is currently trading on the OTC Market Place operated by the OTC Markets Group under the symbol "CANO."

12. The Debtors' workforce, which at one time consisted of approximately 50 employees, now consists of only 27 part-time and full-time employees and 14 contract workers. Nearly all workers at the executive corporate level are independent contractors. After recent departures, the Debtors' Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") were replaced with new management, which is committed to maximizing the value of the Debtors' assets and businesses.

13. The Debtors' operations and assets are located onshore in the United States, in Texas, New Mexico, and Oklahoma. The Debtors have five principal producing properties which are located in: (a) Carson, Gray, and Hutchinson Counties, Texas (the "Texas Panhandle Properties"); (b) Nowata County, Oklahoma (the "Nowata Properties"); (c) Chavez and Roosevelt Counties, New Mexico (the "Cato Properties"); (d) Lincoln County, Oklahoma (the "Davenport Properties"); and (e) central Texas (the "Desdemona Properties").

14. The Debtors' oil and gas business depends heavily on the availability of capital and liquidity. Substantial capital expenditures are needed for the exploitation and the development of crude oil and natural gas reserves. The Debtors' current liquidity constraints have all negatively impacted the Debtors business and their ability to meet their obligations to secured lenders and trade creditors.

B. The Debtors' Indebtedness

15. On December 17, 2008, the Debtors entered into a $120.0 million Amended and Restated Credit Agreement (the "Senior Secured Debt" or the "Senior Credit Agreement") with Union Bank, N.A. ("Union" or the "Senior Pre-Petition Agent") and Natixis (together with Union, the "Senior Secured Lenders"). The Senior Secured Lenders contend that the current

amount outstanding under the Senior Credit Agreement is $60.6 million, with no further borrowing capacity.

16. The Senior Credit Agreement required the Debtors to hedge certain risks relating to oil and gas productions, namely protections against commodity price fluctuations and interest rate fluctuations on the Senior Secured Debt. Consequently, the Debtors entered into certain commodity swap contracts. Due to the termination of certain commodity hedges and an interest rate hedge on August 22, 2011 and September 9, 2011, respectively, the Debtors owe an additional $3.8 million in Senior Secured Debt.

17. On December 17, 2008, the Debtors also entered into a $25 million Subordinated Credit Agreement (the "Junior Credit Agreement") with UnionBanCal Equities, Inc. ("UBE" or the "Junior Pre-Petition Agent"), as the Administrative Agent. UBE asserts that the Debtors currently owe $16.6 million under the Junior Credit Agreement (the "Junior Secured Debt") .

18. The Senior Secured Debt and the Junior Secured Debt are secured by substantially all of the Debtors' assets. The Debtors are in default under the Senior Credit Agreement and the Junior Credit Agreement (collectively, the "Credit Agreements").

C. The Strategic Sales Process

19. The Debtors' declining revenues, continued losses, borrowing constraints, loan defaults and limited-to-no capital availability forced the Debtors to drastically reduce costs, replace management and hire financial advisors to assist in a strategic process.

20. After a lengthy marketing process and substantial discussions with the Pre-Petition Lenders, the Debtors entered into a *Stock Purchase Agreement* dated March 7, 2012 (the "Stalking Horse SPA") with NBI Services, Inc. (the "Stalking Horse"). In accordance with the Stalking Horse SPA, the Debtors agreed to sell and the Stalking Horse agreed to buy all newly-

issued stock in Cano under a plan of reorganization for $47.5 million in cash, subject to certain adjustments and higher and better offers through a competitive auction process (the "Bidding Process").

21. Contemporaneously with the execution of the Stalking Horse SPA and the negotiation of a motion to approve bidding procedures (the "Bid Procedures Motion"), the Senior Secured Lenders and UBE (collectively, the "Pre-Petition Lenders") and the Debtors entered into that certain *Plan Support and Lock-Up Agreement* dated March 7, 2012.

22. The Debtors filed these Cases to effectuate a sale of their equity interests and/or assets. The filing of these Cases and the confirmation of the *Joint Plan of Reorganization*[2] are the Debtors' best option to preserve and maximize the value of their assets and businesses.

23. Additional information regarding the Debtors' businesses, the Stalking Horse SPA, the Plan (including the treatment of all claims), the Bidding Process, and the events leading to these Chapter 11 Cases is contained in the Latimer Declaration.

D. Engagement of Blackhill

24. Since February of 2011, Blackhill Partners, LLC ("Blackhill") has provided the services of James R. Latimer, III ("Latimer") to serve as the Company's CEO and a member of the board of directors (the "Board")[3] as memorialized in that certain engagement letter dated February 10, 2011 (as amended, the "Engagement Letter") by and between Blackhill and Cano. A true and correct copy of the Engagement Letter, as amended, is attached as **Exhibit B**.

25. Pursuant to the Engagement Letter, the Debtors engaged Latimer and Blackhill to assist the Company in (a) evaluating its strategic alternatives, (b) selling the Company's assets, and/or raising additional debt/equity capital for the Company; (c) providing turnaround crisis

[2] Dkt. No. 18.
[3] Original Engagement Letter, ¶1.

management services, and (d) any other tasks that may be requested by the Company.[4] Under the Engagement Letter, the fees and expenses are as follows:

a. Fee Retainer: $75,000

b. Expense Retainer: $10,000.00

c. Monthly Fee: $50,000 per month

d. Termination Fee: $250,000.00

26. The parties amended the Original Engagement Letter by letter dated February 8, 2012 (the "First Amendment") to change Blackhill's compensation from a monthly fee of $50,000 to an hourly rate of $475.00 per hour for Latimer's services effective January 1, 2012. On March 6, 2012, the Engagement Letter was amended by letter (the "Second Amendment") to reduce the Fee Retainer to $45,000.00 and include a success fee (the "Success Fee") of $250,000 in the event that the Plan is confirmed and is effective.

27. In accordance with the terms of the Engagement Letter, Blackhill has a current retainer in the amount of $45,000.00. Before the Petition Date, Blackhill and Latimer earned total fees in the amount of $690,070.68. The amount of fees and expenses disbursed to Blackhill prior to the Petition Date totals $696,681.29. Since the Petition Date, neither Blackhill nor Latimer have not been paid any fees or expenses.

28. Since February of 2011, the Debtors retained Latimer (through Blackhill) to serve as the Debtors' Chief Executive Officer, a member of the Board, and financial advisor. Latimer has used his restructuring expertise to supervise the day-to-day operations and to evaluate and implement the best strategic processes for the Company. Additionally, Laitmer assisted in the preparation and filing of these Cases. Moreover, Latimer has extensive experience and

[4] Original Engagement Letter, ¶1.

knowledge in the field of oil and gas operations and restructurings. Consequently, the Debtors believe that Blackhill and Latimer have developed significant relevant experience regarding the Debtors, has the necessary expertise regarding the Debtors' area of business, and is, thus, both well-qualified and uniquely suited to deal effectively and efficiently with matters that may arise in the context of these Cases.

29. Latimer is the founder and a managing director of Blackhill, and he is principally responsible for the engagement with the Debtors. A summary of Latimer's background, credentials, and experience is set forth in the Blackhill Declaration.

30. Latimer and Blackhill's mailing address and telephone numbers are as follows:

Blackhill Partners, LLC
Attn: James R. Latimer, III
2602 McKinney Avenue, Suite 240
Dallas, Texas 75204
Telephone: 214.382.3750
Facsimile: 214.382.3755

Relief Requested

31. Pursuant to Bankruptcy Code §§ 105(a), 327, 363 and 1107, the Debtors seek authority to engage Blackhill to provide the services of Latimer to serve as the Debtors' Chief Restructuring Officer ("CRO") on terms set forth in the Engagement Letter effective as of the Petition Date. Latimer would continue to serve as the CEO and board member. Based on the Latimer's background and experience, the Debtors believe that the employment and retention of Blackhill as the Debtors' CRO (through Latimer) is necessary and appropriate, in the best interests of the Debtors' estates, their creditors, and all other parties in interest.

32. Subject to the Court's approval of this Application, Latimer and Blackhill have indicated that they are willing to serve as Chief Restructuring Officer for the Company and to perform the services set forth in the Engagement Letter.

Argument and Authorities

A. Employment as a Professional Person

33. Bankruptcy Code § 327(a) authorizes a debtor to employ one or more professional persons, such as attorneys, accountants, appraisers, and auctioneers to represent or perform services for the estate.[5] "To date, courts have not articulated a consistent definition of "professional person" nor a consistent methodology for determining whether or not a particular individual or entity should be categorized as such."[6] The bankruptcy court for the Southern District of New York has defined a professional person as one who plays a central role in estate administration:

> For purposes of Section 327(a), "professional person" is limited to persons in those occupations which play a central role in the administration of the debtor's proceeding. Court approval is required for the retention of attorneys, accountants, appraisers, auctioneers and persons and other professions intimately involved in the administration of the debtor's estate.[7]

Under this definition, many courts have found that the term "professional" includes financial advisors and workout consultants.

34. At the same time, the majority of courts hold that a debtor's corporate officers and directors are *not* "professional persons" whose employment must be court-approved.[8] Even when courts have required approval for officers that are providing consulting services, many

[5] 11 U.S.C. § 327(a).
[6] *In re Bartley Lindsay Co.*, 137 B.R. 305, 308 (D. Minn. 1991).
[7] *In re Seatrain Lines, Inc.*, 13 BR 980, 981 (Bankr. S.D.N.Y. 1981); *see also United States Exrel. Craft v. Aetna Casualty Ins. Co.*, 43 BR 119 (M.D. Tenn. 1984); *In re Lowery Graphics Inc*., 86 BR 74, 78 (Bankr. S.D. Tex 1988).
[8] *In re Fortune Natural Resources Corp.*, 366 B.R. 558, 562 (Bankr. E.D. La. 2007); *In re Lyon & Reboli, Inc.*, 24 B.R. 152, 153-54 (Bankr. E.D.N.Y. 1982)(comparing provisions under the Act to the Code as to officers of a debtor); *In re All Seasons, Indus., Inc.*, 121 B.R. 822, 825 (Bankr. N.D. Ind. 1990) (§ 327(a) could not apply to officers because it results in wholesale removal of all pre-petitions officers who are insiders and not disinterested); *In re Phoenix Steel Corp.*, 110 B.R. 141, 142 (Bankr. D. Del. 1989) ("work out specialists" employed before the bankruptcy to run the company were not professional persons, but compensation subject to court approval); *In re Midland Capital Corp.*, 82 B.R. 233, 239 n.10 (Bankr. S.D.N.Y. 1988) ("Executive officers are simply not professional persons.").

courts have also held that the disinterestedness requirement does not apply.[9] Section 1107 must be read in conjunction with Section 327(a). Section 1107(b) undercuts the disinterestedness requirement by providing that a person is not disqualified from employment by a debtor-in-possession solely because of the person's employment by or representation of the debtor before the commencement of the case.[10]

35. Before the Petition Date, Latimer was employed to replace the outgoing CEO and to provide financial and restructuring services to the Company. Accordingly, on the Petition Date, Latimer served as the Debtors' CEO and a board member. The Debtors hired Blackhill to use Latimer's restructuring expertise to supervise day-to-day operations and to evaluate and implement the best strategic processes of the Company. Thus, neither Latimer nor Blackhill should be deemed a "professional person" under the Code because Blackhill provides Latimer's services as an officer and director of the Company.

36. Likewise, the Debtors contend that they can continue the CRO's retention under Bankruptcy Code § 327(b), which authorizes a debtor to retain salaried persons that the debtor has employed if necessary in the operation of the business. However, because (a) the Debtors contracted with Blackhill to make Latimer available to provide financial consulting services on an hourly basis; (b) the minority view on the need for court approval regarding the employment of officers who also provide consulting services, (c) the need for transparency in services to be performed and the requested compensation as these Cases are proceeding on a relatively expedited track, and (d) limited caselaw in the Fifth Circuit resolving the an consulting officer's

[9] *In re The Crouse Group, Inc.*, 75 B.R. 553 (Bankr. E.D. Pa. 1987)(disqualification under section 327 is not automatic because of lack of disinterestedness); *In re Zerodec Mega Corp.*, 39 B.R. 932, 935 (Bankr. E.D. 1984).
[10] 11 U.S.C. §1107(b).

section 327 employment issue, Blackhill and Latimer have requested that the Debtors obtained an order authorizing their employment.

B. 363 Retention

37. Despite the limited caselaw in this jurisdiction regarding section 327 employment of a debtor's officers and directors providing consulting services, bankruptcy courts in this jurisdiction have authorized such employment under Bankruptcy Code § 363. A debtor's use of property of the estate, pursuant to section 363, both in and outside of the ordinary course of business has been used to employ non-professionals and officers that provide similar services as those being provided by Blackhill and Latimer.[11]

38. Section 363(c) of the Bankruptcy Code authorizes the Debtors to enter into certain transactions and use property of the estate in the ordinary course of business. Arguably, entering into contractual arrangements for the provision of interim management is within the ordinary course of the Debtors' business as contemplated by the Bankruptcy Code, as corporations routinely hire and fire senior executives. Moreover, in particular given the relative speed of these Cases, the absence of executives with a working knowledge of the Debtors' business that are capable of assisting the Debtors would severely hinder the Debtors' ability to reorganize in an efficient and effective manner.

39. Bankruptcy Code § 363(b)(1) is also applicable here, and permits a debtor-in-possession to use property of the estate "other than in the ordinary course of business" after notice and a hearing.[12]

[11] *See, e.g., In re Pilgrim's Pride Corp.*, Case No. 08-45664 (DML)(Bankr. N.D. Tex. 2008); *In re Mirant Corp.* Case No. 03-46590 (DML) (Bankr. N.D. Tex. 2003).
[12] 11 U.S.C. § 363(b)(1).

40. Blackhill, through its and Latimer's experience with both the Debtors and in general, is clearly qualified for the position of CRO for which Blackhill and Latimer are being employed. The Debtors have determined that the terms of the Engagement Letter are within the range of those for senior executive officers employed with companies of comparable size, value and reputation. Accordingly, the Debtors' decision to enter into the Engagement Letter reflects an exercise of the Debtors' sound business judgment.

41. The Debtors request that the Court authorize the CRO's employment pursuant to the Engagement Letter, outside the ordinary course of business, based on the Debtors' sound business justification for doing so.[13] The Debtors and their Board believe that the engagement of Blackhill and Latimer is the best interest of their estates. The business judgment rule provides "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was in the best interests of the company."[14]

C. Review of Compensation

42. Regardless of which section of the Bankruptcy Code under which the Court may allow employment of the CRO, the Debtors seek review of the CRO's compensation. Even courts that have held Bankruptcy Code § 327(a) does not expressly apply to a debtor's officers who are providing consulting services have found that they have the authority to review the officers' compensation for reasonableness.[15] Consequently, the Debtors seek to have all of the

[13] *In re Lionel Corp*., 722 F.2d 1063, 1071 (2d Cir. 1983) (adopted in the Fifth Circuit by *Inst. Creditors of Continental Airlines, Inc. v Continental Airlines, Inc., et al.*, (*In re Continental Airlines, Inc.*), 780 F.2d 1223, 1226 (5th Cir. 1986)); *In re Delaware Hudson Ry. Co*., 124 B.R. 169, 179 (Bankr. D. Del. 1991).
[14] *In re Integrated Resources, Inc*., 147 B.R. 650, 656 (S.D.N.Y. 1992) (quoting *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985)).
[15] *In re Lyon & Reboli, Inc*., 24 B.R. 152 (Bankr. E.D.N.Y. 1982); *In re Athos Steel and Aluminum, Inc*., 69 B.R. 515, 520-21 (Bankr. E.D. Penn. 1987); *C.f. In re Phoenix Steel Corp.*, 110 B.R. 141, 142-43 (Bankr. D. Del. 1989) (employing individuals pursuant to § 327(b)).

CRO's post-petition compensation be subject to any fee or compensation procedures ordered by this Court, including without limitation a review of such compensation for its reasonableness.

43. Subject to Court approval, the Debtors propose to pay Blackhill as compensation for commitment of time and resources of Latimer's services at the rate of $475 per hour. Before the Petition Date, the Debtors paid a retainer to Blackhill in the amount of $45,000, which is being held by Blackhill subject to further order of this Court. The Debtors will also reimburse Latimer and Blackhill for all reasonable out-of-pocket expenses. As set forth in the Engagement Letter, Blackhill is entitled to the Success Fee upon the first to occur of (a) Termination of the Engagement Letter for reasons other than gross negligence and (b) the Plan's effective date. The Pre-Petition Lenders have agreed to the success fee. The Debtors submit that the CRO's compensation as set forth above is reasonable in light of the services to be performed.

D. Indemnification

44. The Engagement Letter includes indemnification provisions that are customary and reasonable for similar engagements, both out of court and in Chapter 11 cases, and reflect the qualifications and limitations on indemnification provisions that are customary in the Fifth Circuit and other jurisdictions.[16]

[16] *See, e.g., In re Pilgrims Pride Corp.*, Case No. 08-45664 (DML) (Bankr. ND Tex, Feb. 9, 2009) (authorizing indemnification provisions relating to the retention of CRO).

Conclusion

45. Before the Petition Date, the Debtor retained Latimer and Blackhill to utilize the Debtors' assets for the best interest of the Company and interested parties based on Latimer's expertise as a "workout specialist". The CRO's engagement is necessary to ensure that the Debtors' have executive leadership that is familiar with the Company and its business and is well-versed in the restructuring process. Without such leadership, the Debtors will be without executives capable of achieving a successful reorganization and their ability to reorganize in an efficient and effective manner would be severely hindered. Through the CRO's efforts, the Debtors have entered into the Stalking Horse SPA for the sale of the Company and reached a consensual Plan with their Pre-Petition Lenders. All of these efforts are paramount to the Debtors' retention of the CRO and demonstrate the benefit to the Debtors' estates. By retaining an objective and skilled professional who provides expertise and guidance, the Debtors will be able to, among other things, evaluate and implement sale and reorganization alternatives.

46. Accordingly, the retention of the CRO is in the best interests of the Debtors' estates, creditors, and other parties-in-interest.

Prayer

WHEREFORE, the Debtors respectfully request that this Court enter an order authorizing the employment and retention of Latimer and Blackhill on the terms set forth in the Engagement Letter effective as of the Petition Date. The Debtors also request such other and further relief as this Court may deem proper, both at law and in equity.

DATED: March 23, 2012.

Respectfully submitted,

THOMPSON & KNIGHT LLP

/s/ Katharine Battaia Clark

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PROPOSED COUNSEL FOR DEBTORS AND DEBTORS-IN-POSSESSION

CERTIFICATE OF CONFERENCE

I certify that on March 23, 2012, I provided a copy of the Application, Blackhill Declaration, and proposed order to the Pre-Petition Lenders and the U.S. Trustee via e-mail. The Debtors will continue to discuss the relief requested with those parties.

/s/ Katharine Battaia Clark
One of Counsel

CERTIFICATE OF SERVICE

I hereby certify that on March 23, 2012, the foregoing was served on all parties entitled to service via the Court's Electronic Filing System ("ECF") and I directed BMC Group, LLC, as service agent, to cause a true and correct copy of the foregoing upon all parties on the Consolidated Master Service List via United States first class mail, postage prepaid.

/s/ Katharine Battaia Clark
One of Counsel