

Breakfast Plenary Session

The Straight and Narrow: Ethics Issues

Disclosure Questions and Beyond

Hon. Ronald G. Pearson, Moderator
U.S. Bankruptcy Court (S.D. W.V.); Charleston

Required Disclosures in Bankruptcy Proceedings and the Consequences of Failure to Disclose

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How Much Disclosure Is Required? Bankruptcy Rule 2019 Disclosures by Ad Hoc Committees

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"I Walk the Line...": Carefully Treading Through Representing an Entity with Insiders Pursuing Divergent Interests

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Pushing the Envelope Under Section 327(e): What Really Constitutes "Special Counsel"?

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Required Disclosures in Bankruptcy Proceedings and the Consequences of Failure to Disclose

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- 1) **Bankruptcy attorneys owe a heightened duty of disclosure to the court. This begins with the employment application and continues throughout the entire representation in the case.**
 - a) The court is required to evaluate whether a professional seeking employment is disinterested and free from adverse interests as set out in U.S. Code §§ 327 and 1103. In order to do this, the professional must disclose all connections to other parties in the case. Bankruptcy Rule 2014 governs this disclosure.
 - i) Federal Bankruptcy Rule of Procedure 2014(a) – Application for order of employment: An order approving the employment of attorneys ... pursuant to § 327, 1103, or 1114 of the Code shall be made only on application of the trustee or committee ... The application shall state ... all of the person’s connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the U.S. trustee or any person employed in the office of the U.S. Trustee. The application shall be accompanied by a verified statement of the person to be employed setting forth the person’s connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the U.S. Trustee or any person employed in the office of the U.S. Trustee.
 - ii) 11 U.S.C. § 327(a) – Except as otherwise provided by this section, the trustee, with the court’s approval, may employ one or more attorneys ... that do not hold or represent an adverse interest to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee’s duties under this title.
 - iii) 11 U.S.C. § 327(e) – The trustee, 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.
 - iv) 11 U.S.C. § 1103(b) – An attorney ... employed to represent a committee appointed under section 1102 of this title may not, while employed by such committee, represent any other entity having an adverse interest in connection with the case. Representation of one or more creditors of the same class as represented by the committee shall not per se constitute the representation of an adverse interest.
 - b) Many types of possible “connections” under Rule 2014(a) must be disclosed, including past and present financial arrangements, representation in multiple proceedings, and

relationships between the attorney and others involved in the proceeding, even where there is no actual conflict.

i) All financial arrangements with parties or those closely related to parties of the action, such as major shareholders, bondholders, or subsidiaries, must be disclosed, even where such arrangements were for prior work that ended before the bankruptcy filing.

(1) In re USA Detergents, Case No. 08-10273 (Bankr. D. Del. May 29, 2008) – The debtor’s majority shareholder owed the law firm representing the debtor an outstanding debt. The law firm did not disclose the existence of this obligation in the law firm’s application to represent the debtor or in its accompanying affidavit. The court ruled that failure to do this was failure to disclose an adverse interest to the estate, thus barring employment.

(2) In re Midway Industrial Contractors, 272 B.R. 651 (Bankr. N.D. Ill. 2001) – Debtor’s counsel had represented the debtor in a prior lawsuit and held a secured claim for payment against the debtor. The law firm did not disclose the claim to the court, which ruled that counsel held an adverse interest to the debtor that it was required to have disclosed in its employment application. As a result, over half counsel’s fees were denied.

(3) In re Mayeaux, 269 B.R. 614 (Bankr. E.D. Tex. 2001) – Debtor’s counsel had represented debtor prior to filing for bankruptcy and received payments six weeks before bankruptcy filing and again after filing. The prior lawsuit was to limit debtor’s civil liability to a client on claims of mismanagement and misappropriation of funds. The court held that the payments must be disclosed because the work done was in debtor’s contemplation of bankruptcy, as is required under Fed. R. Bankr. P. 2016. Failure to disclose these payments left counsel subject to sanctions.

(4) In re Big Rivers Electric Corp., 284 B.R. 580 (W.D. Ky. 2002) – The law firm acting as examiner failed to disclose a bonus fee enhancement agreement it made with the largest unsecured creditors. The court held that this created a conflict that necessitated disclosure, and denied all compensation.

ii) Representation of related parties in multiple proceedings must always be disclosed.

(1) In re C&C Demo, 273 B.R. 502 (Bankr. E.D. Tex. 2001) – The law firm serving as debtor’s counsel in a Chapter 11 proceeding was simultaneously representing the debtor’s equity holders in their individual Chapter 13 proceedings. The law firm was disqualified from representation in the Chapter 11 proceeding and the court remanded to determine sanctions including fee denial. The court would not entertain arguments that the representation did not violate § 327’s disclosure standards, stating that the failure to disclose was enough to bar employment.

- (2) In re BH&P, 949 F.2d 1300 (3d. Cir. 1991) – Counsel represented a closely held corporation and its owners in separate bankruptcy proceedings. Counsel then had to sue the corporation to preserve the owners’ claims, creating a conflict. The court held that the multiple representation, a potential conflict, should have been disclosed in the employment application. Many documents filed referenced the intertwined financial affairs of the owners and the corporation, but the court said these were not sufficient disclosures and that the multiple representations should have been specifically mentioned in the application or accompanying affidavit. As a result, the attorney was only allowed to represent one estate and was denied compensation from the other estates.
- iii) Other relationships existing only outside of bankruptcy proceedings must also be disclosed.
- (1) In re eToys Inc., 331 B.R. 176 (Bankr. D. Del. 2005) – Counsel for the creditors’ committee recommended a restructuring executive to the debtor, who subsequently hired the executive. The attorney and the executive had formed a joint venture unrelated to the bankruptcy proceeding, raising the appearance of a possible conflict. The court allowed the attorney to continue representing the committee. However, failure to disclose the relationship subjected the attorney to potential disgorgement of fees despite the lack of an actual conflict.
- c) Section 327(a) implies a continuing duty, thus the disclosure requirements mandated by Rule 2014(a) continue after employment has commenced, despite the fact that this is not expressly stated in the Rule.
- i) In re Granite Partners, 219 B.R. 22 (Bankr. S.D.N.Y. 1998) – Even where a law firm discloses conflicts in its application, as new ones arise over the course of the proceeding, the law firm is obligated to inform the court, which then decides if the law firm may continue to represent the debtor. In this case, the law firm’s relationship in separate matters with client who was in conflict in the bankruptcy matter grew over the course of the bankruptcy proceeding. The court was concerned that the change in the relationship would affect the attorney’s judgment in acting adversely to the client in the bankruptcy matter. The court found that boilerplate language in the employment application regarding the law firm’s future representation after the bankruptcy action commenced was not an adequate disclosure.
- d) Connections must be disclosed in a complete and straightforward manner. The court does not look through the filings to search for possible conflicts; the attorney must present them. In addition, the court alone decides if a conflict is material, and negligence or inadvertence of nondisclosure is not a defense.
- i) In re Roberts, 75 B.R. 402 (D. Utah 1987) – Counsel had represented the debtor prior to the bankruptcy filing and was a general unsecured creditor for its fee in the earlier representation. The court held that the listing of the law firm on the creditor’s list did

not meet counsel's disclosure requirement. The disclosure had to be stated in its affidavit. The court barred counsel from collecting the outstanding fee and from representing the company, although it did allow counsel to remain involved as representation for the equity holders.

ii) In re BH&P, 949 F.2d 1300 (3d. Cir. 1991) – Counsel's filings referenced intertwined financial affairs between the owners of a closely held corporation and the corporation itself, and counsel sought to represent both the owners and the corporation in separate bankruptcy proceedings. Counsel did not specifically disclose the potential for a conflict between the owners and the corporation in its application. The court stated that it was counsel's job, not the court's, to disclose the potential for a conflict, and that the references to the intertwined financial affairs in filings were not sufficient to meet counsel's disclosure requirements. The subjective good faith belief that counsel had met its disclosure burden was irrelevant to the court.

iii) In re Jore Corp., 298 B.R. 703 (Bankr. D. Mt. 2003) – Counsel to the debtor obtained a limited waiver from a previous client who was a creditor. Counsel failed to disclose to the court the limitations of the waiver for almost a year after counsel began violating the terms of the waiver. The court disqualified counsel and vacated its employment order, holding that counsel had violated its disclosure requirements, regardless of whether the violation was intentional or negligent.

e) Because of the heightened duty of disclosure, where an attorney has knowledge of a conflict, but is not a party to the conflict, the attorney may still face sanctions if he or she fails to disclose facts material to the proceeding.

i) In re Saint Vincents, 2007 WL 2492787 (Bankr. S.D.N.Y. Aug. 29, 2007) – The law firm representing the debtor knew of a merger between the debtor's financial advisor and crisis manager, thus creating a conflict of interest on the part of other estate professionals. The court held that the attorney had a duty to disclose this knowledge to both the court and to the debtor. The law firm itself was disinterested and did not have a conflict of interest; however, the law firm's fees were disallowed from the time it learned of the other professionals' conflict and failed to disclose it to the debtor or court.

2) Attorneys who fail to meet their disclosure requirements face severe consequences, including disqualification, total or partial disgorgement of fees, loss of fees in prior representations, loss of attorney-client privilege, and even criminal penalties. The court has the discretion to disgorge all fees, but generally will resolve the case as it deems equitable in light of the circumstances of the case, recognizing that a violation of the disclosure standard is not a per se violation of the disinterestedness standards of §§ 327 and 1103.

a) Disqualification of counsel is a consequence of lack of disclosure, even after employment has been approved and active representation has begun.

- i) In re C&C Demo, 273 B.R. 502 (Bankr. E.D. Tex. 2001) – The law firm serving as debtor’s counsel was also representing debtor’s equity holders in their individual proceedings and did not disclose this to the court. The court disqualified the law firm from representing the debtor, despite the fact that the debtor was a small company and would be subjected to hardship if forced to change counsel during Chapter 11 proceedings. Additionally, the court would not entertain the idea that the multiple representation would not violate the disinterestedness standard, stating that counsel’s failure to disclose alone was enough to bar employment.
 - ii) In re Jore, 298 B.R. 703 (Bankr. D.Mt. 2003) – Debtor’s counsel violated a limited waiver it received from a creditor and did not inform the court of its violation until almost a year later. Counsel had already placed its final fee application when the violation came to the court’s attention. The court, among other penalties, fully vacated counsel’s employment order.
- b) Fee disgorgement, either partial or total, is another potential consequence for failure to disclose. Willful lack of disclosure will usually merit full fee disgorgement, and courts will commonly order partial disgorgement in cases where they allow representation to continue.
- i) In re Jore, 298 B.R. 703 (Bankr. D.Mt. 2003) – Debtor’s counsel violated a limited waiver it received from a creditor and did not inform the court of its violation until almost a year later. Counsel argued that its violation was negligent and not intentional. Regardless, the court vacated counsel’s employment order, denied the final fee application in the case, and ordered complete disgorgement of all fees previously received, except for expenses related to following the court’s case management order.
 - ii) In re Granite Partners, 219 B.R. 22 (Bankr. S.D.N.Y. 1998) – A law firm representing the debtor failed to disclose that members of the creditors’ committee were also clients, although not in this matter, but this created the appearance of impropriety. Regardless of the fact that there was evidence that the law firm handled its duties zealously and correctly, approximately 60% of its \$4 million in fees were disgorged.
- (1) In re Midway Industrial Contractors, 272 B.R. 651 (Bankr. N.D. Ill. 2001) – Debtor’s counsel held a secured claim for payment against the debtor for prior representation, which counsel did not disclose to the court. The court denied over half of counsel’s fees. One factor the court considered in determining how much of the lawyer’s fees to deny was prejudice to the estate, although it noted that prejudice is not required to deny all fees. The court then went on to consider the expense of responding to the attorney’s lien claim and the cost of objecting to the fee petition in its determination of prejudice. Under this type of analysis, any inquiry into disclosure could result in prejudice to the estate. In this case, the court then disallowed 44% of counsel’s fees, noting that this percentage was consistent with other similar cases in the district.

- iii) In re eToys, 331 B.R. 176 (Bankr. D. Del. 2005) – The attorney recommended an executive who was ultimately hired by the debtor to aid in restructuring. The attorney and the executive had a joint venture that was probably not in actual conflict with the bankruptcy proceeding (the court did not rule on the specific issue of actual conflict), but the attorney did not disclose this relationship. The U.S. Trustee brought charges for disgorgement of fees. Although the attorney and the U.S. Trustee ultimately settled with an arrangement involving partial fee denial, the court approved the settlement in part because it acted as a sanction for the attorney’s lack of disclosure.
- c) Loss of fees from prior representations is another consequence, and may also occur where the court allows the current representation to continue.
 - i) In re Roberts, 75 B.R. 402 (D. Utah 1987) – Counsel was a general unsecured creditor of the debtor it represented for a fee incurred before the debtor’s filing for bankruptcy. Counsel did not adequately disclose this in its employment application. The court barred counsel from collecting the outstanding fee and from representing the company. However, the court did allow counsel to continue to represent the equity holders, because of the equity holders’ strong interest in hiring the attorney of their choice and counsel’s familiarity with equity holders’ finances. Thus the court both punished counsel for its lack of disclosure as well as accommodated the equity holders’ interest.
 - d) Attorney-client privilege can be lost when counsel should have disclosed a conflict to the court.
 - i) In re SonicBlue, 2004 WL 856624 (Bankr. N.D. Cal. Feb. 25, 2004) – A law firm was ordered to produce all work product on a case after it became clear that the law firm had a conflict it failed to disclose. The court ruled that under these circumstances, the attorney-client privilege and work product doctrine did not shield these documents. In addition, the law firm was disqualified as the debtor’s attorney.
 - e) Certain criminal penalties are even available for lack of disclosure.
 - i) 18 U.S.C. § 152 – This section imposes fines and imprisonment for up to 5 years for knowingly and fraudulently making or verifying a false statement or declaration under penalty of perjury to the court in connection with a bankruptcy case.
 - ii) United States v. Gellene, 24 F. Supp. 2d 922 (E.D. Wis. 1998) – Gellene failed to disclose that he represented a large secured creditor in a case in which his firm had been employed as debtor’s counsel. He was sentenced to 15 months in prison for two counts of knowingly and fraudulently making false material declarations under penalty of perjury under 18 U.S.C. § 152 and one count of using a document while under oath knowing it contained a materially false declarations under 18 U.S.C. § 1623.

3) Given the stringent requirements of disclosure and the severe potential penalties, what is a law firm to do?

- a) In re Enron Corp., 2002 WL 32034346 (Bankr. S.D.N.Y. May 23, 2002) – The law firm representing the creditors’ committee had represented the debtor prior to the petition date and had several potential conflicts. The application contained a number of disclosures of potential conflicts as well as a plan to bring in conflicts counsel should that become necessary. When a creditor moved for disqualification, the court found that the firm’s disclosures were adequate and that the objecting creditor was overreaching in order to find a violation by the committee’s counsel.

How Much Disclosure Is Required? Bankruptcy Rule 2019 Disclosures by Ad Hoc Committees

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1. **What is Required to Fully Comply With Bankruptcy Rule 2019?**
 - A. **Rule 2019. Representation of Creditors and Equity Security Holders in Chapter 9 Municipality and Chapter 11 Reorganization Cases**
 - (a) **Data Required.** In a chapter 9 municipality or chapter 11 reorganization case, except with respect to a committee appointed pursuant to § 1102 or 1114 of the Code, every entity or committee representing more than one creditor or equity security holder and, unless otherwise directed by the court, every indenture trustee, shall file a verified statement setting forth
 - (1) the name and address of the creditor or equity security holder;
 - (2) the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition;
 - (3) a recital of the pertinent facts and circumstances in connection with the employment of the entity or indenture trustee, and, in the case of a committee, the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act; and
 - (4) with reference to the time of the employment of the entity, the organization or formation of the committee, or the appearance in the case of any indenture trustee, the amounts of claims or interests owned by the entity, the members of the committee or the indenture trustee, the times when acquired, the amounts paid therefore, and any sales or other disposition thereof. The statement shall include a copy of the instrument, if any, whereby the entity, committee, or indenture trustee is empowered to act on behalf of creditors or equity security holders. A supplemental statement shall be filed promptly, setting forth any material changes in the facts contained in the statement filed pursuant to this subdivision.
 - (b) **Failure To Comply; Effect.** On motion of any party in interest or on its own initiative, the court may
 - (1) determine whether there has been a failure to comply with the provisions of subdivision (a) of this rule or with any other applicable law regulating the activities and personnel of any entity, committee, or indenture trustee or any other impropriety in connection with any solicitation and, if it so determines, the court may refuse to permit that entity, committee, or indenture trustee to be heard further or to intervene in the case;
 - (2) examine any representation provision of a deposit agreement, proxy, trust mortgage, trust indenture, or deed of trust, or committee or other authorization, and any claim or interest acquired by any entity or committee in contemplation or in the course of a case under the Code and grant appropriate relief; and

(3) hold invalid any authority, acceptance, rejection, or objection given, procured, or received by an entity or committee who has not complied with this rule or with § 1125(b) of the Code.

Fed. R. Bankr. Proc. 2019.

- B. In re Northwest Airlines Corp., 363 B.R. 701, 702-03 (Bankr. S.D.N.Y. 2007) (“Northwest Airlines I”) - In Northwest Airlines I, the United States Bankruptcy Court for the Southern District of New York granted the debtor’s motion to require an ad hoc committee of equity security holders to comply with Bankruptcy Rule 2019 by providing timing and pricing information relative to the members’ investments. The 2019 disclosure indicated the amount of stock owned by the committee members in the aggregate, indicated the claims against the debtors of the committee members in the aggregate, and stated that some of the claims were acquired by the committee members post-petition, but provided no detail of stock ownership, claims held or timing of acquisition for each specific committee member. Judge Gropper held that Bankruptcy Rule 2019, “[b]y its plain terms . . . requires disclosure of ‘the amounts of claims or interests owned by the members of the committee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.’” Id. at 702 (quoting Bankruptcy Rule 2019). The Rule 2019 statement at issue there was determined to be insufficient on its face. Id. at 703. See also 9 L. King et al., COLLIER ON BANKRUPTCY ¶ 2019.02 (15th ed. Rev. 2006) (“Any . . . unofficial committee must comply with Rule 2019 by its terms.”) (quoted in In re Oklahoma P.A.C. First Ltd. Partnership, 122 B.R. 387, 391 (Bankr. D. Ariz. 1990)).
- C. In re Sea Containers Ltd., et al., Case No. 06-11156 (KJC) (Bankr. D. Del., May 19, 2008) – The Court required an ad hoc committee of noteholders to comply with only three of the four prongs of 2019(a) – sections 2019(a)(1), (a)(2) and (a)(3), which disclosure the Court held would not impinge on the sensitive area that parties claim would ruin liquidity in chapter 11 cases. The Court did not, however, require compliance with section 2019(a)(4), which calls for the disclosure of the times when acquired, the amounts paid for and any sales or other dispositions, which he ruled was not relevant in the context of this case (although he acknowledged that there could be cases where this information would be relevant in the facts of the case, like Northwest Airlines, where there were conflicted interests since the holders on the ad hoc committee held both debt and equity). Transcript of May 14, 2008 hearing, page 44.

2. **Representation of a Unified Group Purporting to Representing Creditors Broader Than Its Members vs. Representation of a Group of Individual Creditors**

- A. Northwest Airlines I - The ad hoc committee of equity security holders attempted to argue that Rule 2019 only applies, by virtue of its lead in clause, to an entity or committee representing more than one equity security holder or creditor, so Rule 2019 shouldn’t apply since no member of the committee in that case represented a party other than itself and only the law firm represented more than one equity holder. 363 B.R. at 703. The Court rejected that analysis based on the facts of

the case, which indicated that the law firm's client was the committee as whole and not several individual clients. Id. The Court went on to analyze the role ad hoc committees play in a case, whereby "the members purports to speak for a group and implicitly ask the court and other parties to give their positions a degree of credibility appropriate to a unified group with large holdings" and found that these benefits provided to unofficial committees bring them within the purview of Rule 2019. Id.

- B. In re CF Holding Corp., 145 B.R. 124 (Bankr. D. Conn. 1992) – The Court held that in the case of a law firm that represented several individual creditors, the law firm was the only entity required to file a Rule 2019 statement.
- C. In re Scotia Development, LLC, Case No. 07-20027-C-11 (Bankr. S.D. Tex., Apr. 18, 2007) – The Court entered an order ruling that the noteholder group was not a committee, and was therefore not subject to Rule 2019. No opinion accompanied the order so the Court didn't provide further guidance on its reasoning for the ruling, however, the transcript of the hearing indicated that the ad hoc committee represented approximately ninety (90%) percent of the outstanding bonds and it was argued that it wasn't acting to protect anyone not already a member of the group.
- D. Sea Containers – The Court ruled that the ad hoc committee of noteholders was a committee within the meaning of Rule 2019 by looking to the dictionary definition of committee, which says, "Self-constituted organization for the promotion of a common object" and comparing that to the ad hoc committee's stated purposes in their objection which included two common purposes. The Court also held that even if the group wasn't a "committee," the language of Rule 2019 says it applies to "entity or committee" and the definition of entity in section 101 of the Bankruptcy Code is so broad that it would require the ad hoc committee to comply with Rule 2019 even if the group wasn't a "committee." Transcript of May 14, 2008 hearing, page 35.

3. **Sanctions for Failure to Comply**

- A. Court's Discretion - As specified in Bankruptcy Rule 2019(b), upon determining that an ad hoc committee has failed to comply with its disclosure obligations under Bankruptcy Rule 2019, "the court may refuse to permit that . . . committee . . . to be heard further or to intervene in the case" Fed. R. Bankr. P. 2019(b).
- B. Sea Containers – The Court conditioned its decision to not impose the sanction of barring the ad hoc committee's participation in hearings in the case on the committee revising its Rule 2019 statement to provide the information the Court required by a certain date. The Court, however, excused the ad hoc committee from compliance with one of the four prongs of Rule 2019, i.e. Rule 2019(a)(4), on the grounds that it was not relevant in this case. Transcript of May 14, 2008 hearing, page 45.

- C. Northwest Airlines I - In ruling that Rule 2019 had to be complied with, the Court required the ad hoc committee to file an amended 2019 statement within three business days of the entry of the order. 363 B.R. at 704.
4. **Parade of Horribles That Could Result From Requiring 2019 Disclosures of Ad Hoc Committees**
- A. Concern of Hedge Funds
1. Chapter 11 liquidity will dry up because hedge funds and other similar investors will be chilled from buying claims and participating in the bankruptcy process.
 2. Disclosure of the information required by Rule 2019 reveals trading strategy, which should be protected.
- B. Sea Containers – In requiring the disclosure of information contained in three of the prongs of Rule 2019, but not the fourth, the Court noted that the disclosure of information in Rule 2019(a)(1), (a)(2) and (a)(3) wouldn't “impinge on that sensitive area that not only in this case but others have publicly decried would just ruin liquidity in chapter 11 cases.” The Court did not require the disclosure of the information contained in Rule 2019(a)(4), but did so not because of the liquidity concerns, but because he found the information to be irrelevant in this case. Transcript of May 14, 2008 hearing, page 44.
- C. Requests to File 2019 Statements Under Seal to Protect These Concerns
1. In re Northwest Airlines, 363 B.R. 704 (Bankr. S.D.N.Y.) (“Northwest Airlines II”) – The ad hoc committee of equity security holders that were required by Northwest Airlines I to file a Rule 2019 statement regarding its members' purchases of stock sought leave to file it under seal, based on alleged damage to the committee's bargaining position if other parties in interest knew its members' basis or acquisition cost in the Debtor. The Court held that any interest that individual committee members had in keeping this information confidential was overridden by the interests that Rule 2019 is intended to protect, i.e. to protect other members of the group and inform them where a committee is coming from by requiring full disclosure of the securities held by members of the committee and the respective purchases and sales. Id. at 709. The Court found that granting the motion to file under seal “would scuttle the Rule.” Id.
 2. In re Kaiser Aluminum Corp., 327 B.R. 554, 559 (D.Del. 2005) – The District Court upheld an order permitting law firms that represented thousands of asbestos personal injury claimants to file exemplars of documents that empowered them to represent these claimants and making any such information submitted by law firms unavailable on court's electronic docket. After considering section 107(a) of the Bankruptcy Code and its goal of ensuring that information published on the electronic docket is not misused, and in light of the complexity of mass tort litigation, the District Court concluded that the Bankruptcy Court did not abuse its discretion in declining to require the posting of Rule 2019

information on the electronic docket and only making Rule 2019 information available upon motion of a party and order of the Court. See also In re Owens Corning, et al., Case Nos. 00-3837-3854 (JFK) (Bankr. D. Del.), Docket No. 12968, at 55.

5. **Reason Behind the Rule Enactment**

- A. Rule 2019 disclosures foster the public policy interest in favor of access to information about litigants in a bankruptcy case. See FERM v. United States Trustee (In re Crawford), 194 F.3d 954, 960 (9th Cir. 1999) (access to bankruptcy case information “fosters confidence among creditors regarding the fairness of the bankruptcy system”); Express News v. Blackwell (In re Blackwell), 263 B.R. 505, 508 (W.D. Tex. 2000) (the framework regarding protecting information that should be disclosed in a bankruptcy case “begins with the presumption that parties will not proceed in public litigation anonymously”); In re Food Mgmt. Group, LLC, No. 04-22880 (ASH), 2007 WL 458022 at *6 (Bankr. S.D.N.Y. Feb. 13, 2007) (the public policy interest in favor of public disclosure “is at its zenith when issues concerning the integrity and transparency of bankruptcy court proceedings are involved”); CF Holding, 145 B.R. at 126 (purpose of Rule 2019 is to foster goal of complete disclosure during business reorganization process).
- B. According to Colliers, “the Rule is part of a disclosure scheme of the Bankruptcy Code and is designed to foster the goal of reorganization plans which deal fairly with creditors and which are arrived at openly. Rule 2019 has been used as a control device to provide to stakeholders complete disclosure of material facts in the solicitation and voting process and to prevent conflicts of interest among creditors’ counsel from undermining the fairness of the plan process.” 9 Lawrence P. King, et al., Collier on Bankruptcy § 2019.01 (15th ed. 2004).
- B. Kaiser Aluminum, 327 B.R. at 559 (noting in the context of disclosure of representation of thousands of asbestos personal injury claimants that “the purpose of Rule 2019 is to ensure that plans of reorganization are negotiated and voted upon by people who are authorized to act on behalf of the real parties in interest.” (citing 9 Lawrence P. King, et al., Collier on Bankruptcy § 2019.05[2] (15th ed. 2004))).
- C. Northwest Airlines II – Rule 2019 is intended to provide other members of an ad hoc committee a right to information as to committee member purchases and sales so that they make an informed decision whether this committee will represent their interests or whether they should consider forming a more broadly-based committee of their own. 363 B.R. at 709. It also gives all parties a better ability to gauge the credibility of an important group that has chosen to appear in a bankruptcy case and play a major role. Id.
- D. Origin of Rule 2019 - As noted by the Court in Northwest II, “The direct antecedent of Rule 2019 was Rule 10-211 under former Chapter X of the Bankruptcy Act, which was adopted following an exhaustive SEC Report on the

Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1937) (hereafter, the “SEC Report”). Among other things, the SEC Report warned of possible conflicts of interest by outside as well as inside financial interests, finding that “these conflicts permeate the entire protective committee system. Their elimination is as essential towards making the outside groups effective and responsible as it is towards eliminating the abuses of the insiders.” SEC Report, Part I at 880. As one step toward this end, the Commission recommended that persons who represent more than 12 creditors or stockholders (including committees) be required to file with the court a sworn statement containing the information now required by Rule 2019. The Report also recommended that “[a]ttorneys who appear in the proceedings should be required to furnish similar information respecting their clients.” The SEC specifically found that the foregoing information “will provide a routine method of advising the court and all parties in interest of the actual economic interest of all persons participating in the proceedings.” Recommendation 9, SEC Report, Part I at 902 (emphasis added.)”

D. Should Rule 2019 be modified?

Sea Containers – The Court discussed the original reason for Rule 2019 in saying: “And I can see from the language of the rule in part that it was designed to deal with the issues which form the basis for the rule as it was promulgated many years ago. So that everyone would know who was behind the committee. In other words, that it wasn’t being manipulated by the debtor, that it was a simple way of explaining the problem that gave rise to this rule.” Transcript of May 14, 2008 hearing, page 43. The Court goes on to state that: “I do think that the rule has to be modified to address the situation that is coming up with increasing regularity But I think the exercise, at least for now, has to be one of balancing the interests, not just of the parties but of the particular context with sensitivity to the particular context in which the issue arises. And always keeping in mind that the rules should be read as Rule 1001 provides, to secure the just, speedy, and inexpensive determination of every case and proceeding.” Transcript of May 14, 2008 hearing, page 47.

“I Walk the Line...”: Carefully Treading Through Representing an Entity with Insiders Pursuing Divergent Interests

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I. Introduction.

When meeting with directors and/or officers (for purposes of this discussion “D/O”) of an entity that is dealing with financial challenges and/or considering a bankruptcy proceeding, it is almost inevitable that the D/O will ask what the bankruptcy consequences will be for them on an individual basis.

In your effort to demonstrate the breadth of knowledge, and keeping in mind who makes the ultimate decision to hire you, you may provide a general outline of what may come for them and recommend that they retain separate counsel in order to pursue their rights and interests in the case.

In a perfect world, the D/O will understand their fiduciary duties and you would only have to remind them of same. Also in a perfect world, the D/O will not have a substantial claim, an interest in “buying” the company, or have transgressions that, when viewed under a bankruptcy microscope, would lead to litigation (or their outster).

Well, since the world is not always perfect, this section will briefly address scenarios that may arise where your representation of the entity and its interests may intersect (or better yet, diverge) with the D/O's individual interests.

A. Fiduciary Duties.

One of the first discussions with the D/O will be a reminder of the directors and officers fiduciary duties. Using Delaware law as an example, these duties are governed by the Delaware General Corporation Law (the "DGCL").¹ The DGCL provides that the "business and affairs of every corporation . . . be managed by or under the direction of a board of directors . . ." 8 Del. C. 141(a). A basic tenet of corporate law is that in discharging its duty to manage the business and affairs of a corporation, the board of directors owes fiduciary duties to the corporation and its stockholders. These fiduciary duties include the duty of care, the duty of loyalty and the duty of disclosure.

1. Duty of Care

The duty of care requires that directors act on an informed basis after due consideration of relevant information, including the input of legal and financial experts. This

¹ A special thank you to the law firms of Morgan Lewis & Bockius and Duane Morris (specifically Rebecca Booth and Matthew Hoffman) who have granted permission to use excerpts of their written work for the Eastern District of Pennsylvania Bankruptcy Conference held this past winter.

means that directors should act only after they believe that they have obtained all necessary information, and have had the opportunity and time to deliberate fully. In determining whether the directors have satisfied their duty of care, a court will review and examine director attendance at board meetings, the frequency and duration of such board meetings, directors' knowledge of the subject matter of the transaction at issue and whether there was an appropriate level and amount of deliberation. *See generally Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

While the duty of care is the responsibility of the board of directors, the DGCL specifically authorizes directors to use outside experts to advise the board of directors on significant legal and financial matters affecting their analysis.

2. Duty of Loyalty

The duty of loyalty requires that directors act in good faith in a disinterested manner. Good faith contemplates that an action is intended to be taken for the best interest of the corporation and its stockholders and for a rational business purpose. Disinterestedness means that a director has no material personal or financial interest in a transaction that is not shared by stockholders generally. Thus, a director who serves as an officer or employee of the corporation, who is a member of a firm receiving substantial revenue from the corporation, or who receives a material benefit from a transaction not received on an equivalent basis by all of the stockholders of the corporation may be viewed as having a self-interest in the transaction. A director also may be interested where a corporate decision will have a materially detrimental impact on the director, but not on the corporation or the stockholders. In all events, the conflict of interest between the director and the corporation or its stockholders must be substantial, actual and imminent, and not speculative and remote, for it to result in the director being considered to be interested.

3. Duty of Disclosure

In addition to their duties of care and loyalty, the directors of a Delaware corporation also owe a duty of disclosure to the corporation's stockholders. In disclosing matters relating to a business combination to a corporation's stockholders, the board of directors must act in a manner consistent with its duty to disclose fully all material facts within its control that would have a significant effect upon the stockholders' decision to approve or reject the transaction.

When soliciting stockholder action, directors are required to disclose all material information concerning the stockholder decision in question, whether it be a matter of corporate governance or a corporate transaction. As stated by the Delaware Supreme Court, "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976)). That is, a fact is material if there is a substantial likelihood that its disclosure would have been viewed by a reasonable stockholder as significantly altering the total mix of available information.

Delaware courts have also indicated that directors have a fiduciary obligation to disclose information to other directors of the same corporation. As with disclosure to stockholders

in connection with a stockholder decision, only material facts need be disclosed to fellow directors.

4. Shifting Duties in the Zone of Insolvency

It is widely accepted that as an entity becomes insolvent (or within the “zone” of insolvency) the aforementioned duties extend also to creditors of the entity in addition to shareholders.

B. Business Judgment Rule

Another important aspect of corporate law concerns the standards by which the directors and/or officers’ decisions will be analyzed.

If a claim arises alleging that directors have breached their fiduciary duties, then Delaware courts generally review the decisions made by the board of directors under a standard of review that has come to be known as the “business judgment rule.” The business judgment rule is important because it limits judicial scrutiny of the directors’ decisions if they acted with due care, in good faith and in a disinterested manner. Where the business judgment rule applies, courts will not substitute their own notions of what might constitute sound business judgment for the decisions made by the directors. The business judgment rule, therefore, offers directors a level of protection from liability.

The business judgment rule also provides a legal presumption in favor of the directors. Under the business judgment rule, directors’ decisions are presumed to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation. In instances where the business judgment rule applies, a plaintiff alleging breach of fiduciary duty has the burden of rebutting this presumption. Directors’ decisions are protected unless the plaintiff is able to meet its burden of proof in showing that the board of directors has not met its duty of care or duty of loyalty. When the business judgment rule applies, a court will give great deference to the substance of the directors’ decision and will not invalidate the decision, will not examine its reasonableness, and will not substitute its views for those of the board if the board’s decision can be attributed to any rational business purpose.

C. Sale of Control

There are limited situations in which Delaware courts will not defer to board conduct under the application of the business judgment rule and will instead exercise “enhanced scrutiny” to determine if the directors breached their fiduciary duties. These arise primarily in two areas: (1) approval of a transaction involving a sale of control and/or a break-up of the company (“*Revlon* duties”); and (2) adoption of a defensive mechanism in response to an alleged threat to corporate control or policy (“*Unocal* standard”). These have taken their names from the cases that made them famous: “*Revlon* duties” in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), and “*Unocal* standard” in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

When a court determines that either *Revlon* duties or the *Unocal* standard has been implicated, the board’s actions and its decision-making process are scrutinized and considered to

a much greater degree than would be the case if the business judgment rule were applicable. Under this enhanced scrutiny test, the court will examine the reasonableness of the directors' decision. In addition, unlike under the deferential business judgment rule, the directors bear the burden of proving that their process and conduct satisfy the court's enhanced standard of review. *Revlon* duties generally require the board of directors of the selling corporation to seek the "maximization of the company's value at a sale for the stockholders' benefit. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986). Accordingly, to satisfy its fiduciary duties the board must obtain the "highest value reasonably attainable for the shareholders." *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1288 (Del. 1989). The *Unocal* standard requires that the board satisfy the two-prong burden of demonstrating that (i) the directors had a reasonable belief that there was a legitimate threat to corporate control or policy, and (ii) there was a reasonable relationship between the threat and the defensive tactics employed. Under both the *Revlon* duties and the *Unocal* standard, the actions and decision-making process of a board will be subject to enhanced judicial scrutiny.

II. Application of Duties/Standards to Various Bankruptcy Planning Issues:

During the course of the representation (especially of a closely held entity), various scenarios may arise that present a challenge to the attorney's ability to most effectively represent the client. Aside from reminding the D/O of their fiduciary duties, the attorney must consider his or her own responsibilities when serving as attorney in this difficult representation.

In these instances, the attorney must recall Model Rule 1.8 and 1.13 that provides:

Model Rule of Professional Conduct 1.13: Representation

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.

(c) Except as provided in paragraph (d), if

(1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization.

Then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

(d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

(e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.

(f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interest are adverse to those of the constituents with whom the lawyer is dealing.

(g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

Clearly one distinguishing feature of business lawyering is the frequent presence of an organizational client, such as a corporation. Lawyers' duties in such representations can run in numerous directions, depending on who is identified as the client. See MRPC 1.13(g). As suggested by the title of this subsection, a real question may arise – who is the client? There, the attorney must undertake an analysis of the actual and potential conflicts that may arise, and in so doing must outline his or her role, including the limitations of the relationship.

**Model Rule of Professional Conduct 1.8:
Conflict of Interest: Current Clients: Specific Rules**

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

- (1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client.
 - (2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and
 - (3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.
- (b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent, except as permitted or required by these Rules.
- (c) A lawyer shall not solicit any substantial gift from a client, including a testamentary gift, or prepare on behalf of a client an instrument giving the lawyer or a person related to the lawyer any substantial gift unless the lawyer or other recipient of the gift is related to the client. For purposes of this paragraph, related persons include a spouse, child, grandchild, parent, grandparent or other relative or individual with whom the lawyer or the client maintains a close, familial relationship.
- (d) Prior to the conclusion of representation of a client, a lawyer shall not make or negotiate an agreement giving the lawyer literary or media rights to a portrayal or account based in substantial part on information relating to the representation.
- (e) A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:
- (1) a lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter; and
 - (2) a lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client.
- (f) A lawyer shall not accept compensation for representing a client from one other than the client unless:
- (1) the client gives informed consent;
 - (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
 - (3) information relating to representation of a client is protected as required by Rule 1.6.

(g) A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, or in a criminal case an aggregated agreement as to guilty or nolo contendere pleas, unless each client gives informed consent, in a writing signed by the client. The lawyer's disclosure shall include the existence and nature of all the claims or pleas involved and of the participation of each person in the settlement.

(h) A lawyer shall not:

(1) make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement; or

(2) settle a claim or potential claim for such liability with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith.

(i) A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:

(1) acquire a lien authorized by law to secure the lawyer's fee or expenses; and

(2) contract with a client for a reasonable contingent fee in a civil case.

(j) A lawyer shall not have sexual relations with a client unless a consensual sexual relationship existed between them when the client-lawyer relationship commenced.

(k) While lawyers are associated in a firm, a prohibition in the foregoing paragraphs (a) through (i) that applies to any one of them shall apply to all of them.

Note that, while multiple representations of the entity and its directors and officers outside of bankruptcy is not a per se violation, See MRPC 1.13(g) and 1.8., it is potentially challenging in bankruptcy scenarios, as set forth below:

A. Insider Financing

When an insider proposes to provide debtor in possession financing, it poses unique challenges. From a representation perspective it appears to directly challenge MRPC 1.8(g). From a bankruptcy perspective, the challenge arises in that the debtor entity, who no doubt requires some form of additional cash, will be put to the test that it *inter alia* made a thorough investigation of its financing alternatives.

This analysis will be especially acute where the financing is proposed to be provided by an insider. Are the terms arm's length? Should this be deemed equity rather than debt? Does it provide additional and unreasonable control over the debtor? Clearly, this scenario mandates separate counsel for the insider and requires that debtors counsel steer clear from appearances of impropriety, primarily by ensuring that proper disclosure is made to the Court at every possible stage.

B. Officers/Directors demanding company to institute KEIP

Another circumstance that often arises concerns the D/O's desire to be paid, which may include a demand for compensation that reflects his or her willingness to stay on board through the bankruptcy proceeding. Besides explaining that the old "stay bonuses" are a thing of the past, the attorney is put in the tough position to tell the very D/O who hired the attorney that the D/O might not be able to obtain compensation other than what was agreed pre-petition and that post-petition modifications are viewed with increasing scrutiny requiring court approval. Among other things, that might lead to a conversation between counsel and the D/O regarding the pre-petition establishment of a compensation plan which would account for the new bankruptcy laws and provides the additional compensation sought by the D/O.

By way of background, as we all are aware, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 drastically limited a debtor's ability to implement key employee retention plans (KERPs). Congress limited the use of KERPs in an effort to curb what was perceived as abuses in some of the largest bankruptcy cases, including Enron, where senior executives were given generous bonuses as part of retention plans while the company was, among other things, laying off numerous employees. Under the new law, the bankruptcy court's discretion in approving KERPs for senior executives is limited, thus protecting the less senior employees of the debtor. However, there are potential ways around these provisions. Specifically, the new provisions do not apply to payments made to senior executives in accordance with existing arrangements that are common and not considered outside of the ordinary course of business. Further, the restrictive statute has been somewhat overcome by the creation of Key Employee Incentive Plans where additional compensation may be achieved by meeting certain benchmarks (not related exclusively to staying with the company).

Setting aside the role of whether it is appropriate for the attorney to counsel the D/O as to the appropriate compensation and methodology for implementation (although the attorney could safely counsel the board and let them make their own informed decisions) it raises an interesting question as to whether certain pre-petition "planning" acts are ethical.

As noted, applying the Model Rules of Professional Conduct to bankruptcy planning and asset protection presents some difficult and perhaps unresolved ethical questions. The following rules will likely come into play when a client engages counsel to assist in pre-bankruptcy planning and establishes an asset protection plan.

Rules of Professional Conduct Rule 1.2 -- Scope of Representation

"(d) A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal

consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law. "

This raises certain questions for debate:

(i) Will "bankruptcy planning" or asset protection strategies that are designed to frustrate and impede creditors or other stakeholders, or divest the local court of jurisdiction, be deemed an "obstruction of justice" and thus "criminal" for purposes of Rule 1.2?

(ii) Will a structure designed to render unenforceable state or federal fraudulent conveyance laws be considered fraudulent for purposes of Rule 1.2?

When considering these questions, it shall be recalled that Rule 1.2(d) provides that a lawyer shall not counsel a client to engage in conduct that the lawyer knows is fraudulent. At first blush, creative pre-bankruptcy planning and the creation of an asset protection plan does not appear to be fraudulent. There is, on the surface, no effort to deceive anyone. However, one purpose of such steps is clearly an effort to block creditors or impede their interests. More specifically, the primary purpose of a reworked compensation package in which the executive obtains substantial interest is to prevent such assets from being paid to creditors while the executive(s) retains a substantial interest. Again, the most prudent way to accomplish the goal of the company is to have the company make an informed decision (which may include consultations with outside experts) and make appropriate disclosure to the Court.

C. Officers/Directors Demanding Releases in the Plan

Similar to the KERP/KEIP request, when formulating a bankruptcy plan, the D/O may insist upon a release of third parties, such as him or herself that would help insulate that party from claims of wrongdoing. Clearly, such releases are only provided on a limited basis and the attorney must therefore explain the limitations. Then, the additional conflict arises where the attorney must help the entity weigh the validity, necessity and value of such releases (most likely conducting that analysis with the very parties insisting upon the release).

Much like Rule 1.13(g), the entity/individual must keep in mind their fiduciary duties when evaluating provisions which may have the effect of benefiting more than just the bankrupt entity. Thus, should the company wish to seek approval of the releases, the attorneys must be willing to squarely disclose such releases and prepare to defend their validity.

D. "Bankruptcy Planning" Issues:

1. Slow Pay
2. Run Up Inventory
3. Preferences

Akin to the pre-filing revised compensation plans, there will be certain pre-bankruptcy planning tools that a debtor may consider. As counsel to such an entity, one must be mindful of

the tension between advocacy and encouragement of surpassing the legal and/or ethical boundaries.

Counseling a client to use bankruptcy planning and asset protection measures requires careful consideration of the Rules of Professional Conduct. A violation may arguably occur even where the attorney has no knowledge of any fraud or intent to defraud on the part of the client. On the other hand, advising a client to plan for bankruptcy filing by taking certain asset protection measures arguably constitutes no violation of these rules, and instead merely allows the client to take advantage of favorable laws duly enacted in jurisdictions unfavorable to creditors.

A topic for debate is whether any of these acts are ethically better or worse than the next.

E. Asset Sales to Insiders.

Finally, much like the financing by insiders, the circumstance often arises in closely held businesses where an insider or a group of insiders wishes to “buy” the assets out of bankruptcy. Besides the myriad of section 363 issues this presents (sale price, break-up fee) and the heightened review of the sale process and the debtor’s exercise of proper business judgment, it poses potential difficulties for the attorney of the debtor in that it requires the debtor’s attorney to negotiate in an arms length transaction with certain (if not all) of the parties which were behind the entity’s retention of that attorney in the first instance.

In order to alleviate the potential appearance of impropriety, it is imperative that the attorney strictly adhere to a formal and open sale process which does not seek relief for the buyers’ benefit in excess of what is appropriate. Plainly the insiders maintain their own fiduciary duties which they have to reconcile on their own (and hopefully with their own counsel that you recommended they hire), but it poses ethical challenges for the attorney. The aforementioned open section 363 sale process will help alleviate such concerns, but only if conducted properly. Failure to do so would potentially be fatal to a sale to insiders in that a Court could not permit a transaction that does not meet the appropriate standards, especially where insiders are concerned.

Other Potential Relevant Rules Regarding Bankruptcy Planning

1. Rules of Professional Conduct Rule 1.16 -- Declining or Terminating Representation

(a) Except as stated in paragraph (c) [court orders lawyer to continue representation], a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if: (1) the representation will result in violation of the Rules of Professional Conduct or other law . . .

2. Rules of Professional Conduct Rule 4.4 -- Respect for Rights of Third Persons

"(a) In representing a client, a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person, or use methods of obtaining evidence that violate the legal rights of such a person.. . ."

3. Rules of Professional Conduct Rule 3.3 -- Candor toward the Tribunal

"(a) A lawyer shall not knowingly:

(1) make a false statement of material fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer;

(2) fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel; or

(3) offer evidence that the lawyer knows to be false. If a lawyer, the lawyer's client, or a witness called by the lawyer, has offered material evidence before a tribunal or in an ancillary proceeding conducted pursuant to a tribunal's adjudicative authority, such as a deposition, and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal. A lawyer may refuse to offer evidence, other than the testimony of a defendant in a criminal matter, that the lawyer reasonably believes is false.

(b) A lawyer who represents a client in an adjudicative proceeding and who knows that a person intends to engage, is engaging or has engaged in criminal or fraudulent conduct related to the proceeding shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal.

(c) The duties stated in paragraphs (a) and (b) continue to the conclusion of the proceeding, and apply even if compliance requires disclosure of information otherwise protected by Rule 1.6.

(d) In an ex parte proceeding, a lawyer shall inform the tribunal of all material facts known to the lawyer that will enable the tribunal to make an informed decision, whether or not the facts are adverse."

III. Attorney Disciplinary Proceedings

Issues relevant to pre-bankruptcy and asset protection planning have been the subject of numerous attorney disciplinary proceedings.

An excellent example is *In re Kenyon and Lusk*, 327 S.C. 307, 491 S.E.2d 252 (1997), wherein an attorney who counseled a client in connection with a conveyance of property designed to frustrate creditors was suspended for 15 months:

"[A]cts sufficient to constitute the civil definition of fraudulent conveyances do not have to be found for us to find misconduct. We do not have to find fraudulent conveyances – only fraudulent or dishonest conduct. In *In re Hockett*, 303 Ore. 150, 734 P.2d 877 (1987), an attorney disciplinary proceeding involving an attorney who assisted his client in transferring assets to avoid creditors, the court found no tortious fraudulent conveyances. However, the court specifically found that “assisting clients to cheat creditors is ‘dishonesty’ under DR 1-102(A)(4)”. We find respondents committed misconduct in conveying this property.

Other jurisdictions have also addressed situations involving similar misconduct and fraudulent conveyances. Florida Bar v. Scott, 566 So.2d 765 (Fla. 1990) (attorney who concealed property for a friend to avoid creditors committed misconduct); In the Matter of Breen, 113 N.J. 522, 552 A.2d 105 (1989) (attorney who fraudulently prepared four mortgages against his residence and transferred title to a friend to defraud creditors was disbarred); In the Matter of De Pamphilis, 30 N.J. 470, 153 A.2d 680 (1959) (attorney received public reprimand for recommending transfers to defraud creditors); In re Hockett, 303 Ore. 150, 734 P.2d 877 (1987) (attorney who handled divorce proceeding so as to preclude creditors of husband from obtaining assets through fraudulent conveyances was suspended)."

Pushing the envelope under Section 327 (e) : What really constitutes “special counsel”?

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Section 327 as a whole governs the terms and conditions of the employment of attorneys and other professionals in a bankruptcy case. To be employed as bankruptcy counsel under section 327(a), debtor's counsel and other professionals must satisfy two requirements: 1) they must not hold or represent an interest adverse to the estate; and 2) they must be disinterested persons within the meaning of the Bankruptcy Code.²

The mechanism for determining whether a professional holds an interest adverse to the debtor or to the estate is set forth in the Federal Rules of Bankruptcy Procedure; but the Third Circuit and other courts have defined an "adverse interest" as any economic interest that would tend to lessen the value of the bankruptcy estate or create an actual or potential dispute with the estate, or a predisposition of bias against the estate.³

A “disinterested person” under the Bankruptcy Code is one who "does not have an interest materially adverse to the interest of the estate" – encompassing a whole host of enumerated disqualifying relationships with a debtor; including a creditor, shareholder, officer, director or employee⁴. In connection with a request to be retained as 327 counsel, a prospective professional must submit an application and accompanying verified statement under Rule 2014 (a) which discloses all known and potential conflicts of interest with the various parties in or related to the case.⁵ Accordingly, section 327(a) is stringent in its requirement that attorneys and other professionals to be free of both actual and potential conflicts of interest that could impair their duties to the debtor and the estate.

More and more frequently, courts are seeing 327 (e) applications from debtors who would otherwise not be permitted to employ an existing attorney as its bankruptcy counsel under section 327(a). In these cases, the debtor, upon court approval, may employ counsel for a specified special purpose under 11 U.S.C. § 327(e). Under section 327(e), “special counsel” may be appointed if:

- (1) the representation is in the best interest of the estate;
- (2) the attorney represented the debtor in the past;
- (3) the attorney's representation is limited to a specific purpose approved by the court, other than to represent the debtor in conducting the case; and

² 11 USC s 327 (a).

³ Fed. R. Bankr. P. 2014 (a); *In re BH&P, Inc.*, 949 F.2d 1300, 1308 (3d Cir. 1991) (defining an adverse interest as an "interest or relationship that would even faintly color the independence and impartial attitude required by the Code.").

⁴ 11 U.S.C. § 101(14) defines the term "disinterested person" as a person who is not a creditor, an equity security holder, or an insider; does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason. 11 U.S.C. 101 (14).

⁵ Fed. R. Bankr. P. 2014(a).

(4) the attorney does not represent or hold an interest adverse to the debtor or the debtor's estate regarding the matter on which the attorney is to be employed.⁶

Although the legislative history and case law hold that such “special counsel” roles be limited to extraordinarily complex cases or cases “where changing attorneys in the middle of the case after the bankruptcy has commenced would be detrimental to the progress of that other litigation”,⁷ the courts have been considering these applications on a case by case basis, determining the facts and circumstances surrounding each case. To preclude the circumvention of the general standards of retention under section 327(a), the section 327(e) “special counsel” role must not be expanded to represent the trustee or debtor in possession in conducting the case.

Why 327 (e)?

In addition to the “specified specific purpose” the legislature envisioned as the basis for 327 (e) counsel, there are seemingly more practical reasons that debtors are increasingly filing applications for 327 (e) counsel. In many cases, the counsel of choice for the debtor in possession cannot serve as the estate's general bankruptcy counsel because it has represented the debtor and thus has a 327(a) retention problem. Because a creditor is not a “disinterested person” under the Code, if proposed general bankruptcy counsel has been representing the prospective debtor in possession, there is generally a large fee outstanding, creating a disqualifying creditor relationship.⁸ Moreover, a partner at a large firm may have acted as an officer of the debtors. In Delaware, lack of disinterestedness of one partner is imputed to the law firm.⁹

Although an attorney's lack of disinterestedness may preclude employment by the estate for general purposes in conducting a bankruptcy case, the attorney may still be retained by the estate under 327 (e) for a “special purpose.” Section 327(e) provides that, when it is in the best interest of the estate, the trustee may employ, for a “specified purpose,” other than to represent the trustee in “conducting the case,” an attorney who has represented the debtor. Such attorney need not be “disinterested,” as is otherwise required by section 327(a), provided that the attorney represents or holds no interest adverse to the debtor or to the estate with respect to the matter upon which the attorney is to be engaged.¹⁰ Prospective counsel who is unwilling to waive its substantial pre-petition fee, therefore, may nevertheless be able to be retained for “a specified specific purpose” under section 327(e), provided that such retention is in the best interest of the estate. When requesting 327 (e) retention, counsel should be mindful of a necessary division of

⁶ 11 U.S.C. § 327(e); *In re Woodworkers Warehouse, Inc.*, 323 B.R. 403, 406 (D. Del. 2005); *Meespierson, Inc. v. Strategic Telecom, Inc.*, 202 B.R. 845, 847 (D. Del. 1996); *see also In re Gelsing*, 2000 WL 136812, 2 (E.D. Pa. 2000); *In re DeVlieg, Inc.*, 174 B.R. 497, 502-04 (N.D. Ill. 1994).

⁷ *Id.*

⁸ *See, e.g., In re Pillowtex, Inc.*, 304 F.3d 246 (3rd Cir. 2002); *United States Trustee v. Price Waterhouse*, 19 F.2d 138 (3rd Cir. 1994).

⁹ *In re Essential Therapeutics, Inc.*, 295 B.R. 203 (Bankr. D. Del. 2003).

¹⁰ *In re EBW Laser, Inc.*, 333 B.R. 351, 359 (Bankr. M.D.N.C. 2005) (counsel not disqualified under section 327(e) because it holds prepetition claim); *In re Albert*, 206 B.R. 636, 644 (Bankr. D. Mass. 1997) (distinguishing the disinterested requirement in subsection 327(a) from the adverse interest requirement of subsections 327(c) and (e)); *In re Black & White Cab Co.*, 175 B.R. 24, 25 (Bankr. E.D. Ark. 1994); *In re Hub Business Forms, Inc.* 146 B.R. 315 (Bankr. D. Mass. 1992) (because of limited scope of employment, special counsel need not be disinterested; however, special counsel may not hold or represent an interest adverse to the estate); *In re G & H Steel Serv., Inc.*, 76 B.R. 508 (Bankr. E.D. Pa. 1987).

labor between the two (or more) sets of counsel. Under no circumstances should an attorney retained under section 327(e), be "conducting the case", and should be in a supportive role only, specifically delineated in the application.

In many cases, where sprawling firms represent large institutional clients, lead bankruptcy counsel or the debtor in possession may be conflicted because his firm represents one or more of the creditors. While the Bankruptcy Code permits counsel to represent both the debtor in possession and the creditor as long as the concurrent representation does not pose an actual conflict,¹¹ the rules governing professional conduct may prevent it. This is often resolved by hiring another bankruptcy lawyer for the debtor in possession to serve as "conflicts counsel" and the representation may continue. Alternatively, it is another situation where counsel attempts to narrow its scope to fit into the 327 (e) exception.

What constitutes "conducting the case"?

The term "conducting the case" is not defined in the Bankruptcy Code. When considering the retention application of special counsel under section 327(e), courts consider all relevant facts surrounding the debtor's case, including, but not limited to, the nature of the debtor's business, the foreseeable employment of special counsel, the history between the debtor and proposed special counsel, the expense of replacement counsel, potential conflicts of interest and the role of general counsel.¹²

Often debtors have a legitimate need to hire counsel with expertise in non-bankruptcy matters and 327 (e) is specifically drafted for this purpose. If the debtor seeks to employ bankruptcy lawyers as special counsel under section 327(e), the scope of their activities must be clearly delineated, and it is essential that they are prohibited from representing the debtor in "conducting the case." *Woodworkers* and its progeny have suggested that the 327 (e) counsel will be approved where the debtor has retained general bankruptcy counsel to oversee core bankruptcy functions, which it enumerates as advising the debtor of its duties and powers; formulating, negotiating, finalizing and seeking confirmation of a plan of reorganization; reviewing and objecting to claims; pursuing recovery of preferences and fraudulent conveyances, and providing for asset distribution to creditors.¹³ Citing a central purpose behind Section 327 (e) as the avoidance of unnecessary duplication of services at the expense of the estate,¹⁴ the Court in *Woodworkers* makes it plain that as long as the general bankruptcy counsel has a prominent role and the 327 (e) tasks are specifically defined to not substantially overlap with those of general bankruptcy counsel, the 327 (e) application will likely be granted.¹⁵ In doing so, the Court cautions the prospective 327 (e) counsel from attempting to usurp the case.¹⁶

¹¹ 11 U.S.C. § 327(c).

¹² See *Woodworkers*, 323 B.R. at 406; *In the Matter of First American Health Care of Georgia, Inc.*, 1996 WL 33404562, *3 (Bankr. S.D. Ga. Apr. 18, 1996).

¹³ See *Woodworkers*, 323 B.R. at 407-08.

¹⁴ *Id.*, and see *DeVlieg*, 174 B.R. at 503 (citing *In re NRG Resources*, 64 B.R. 643, 647 (W.D. La. 1986).

¹⁵ *Id.*

¹⁶ *Id.* (citing *In re Argus Group 1700, Inc.*, 199 B.R. 525 (Bankr. E.D. Pa. 1996), declining to appoint special counsel to pursue specific litigation which was sine qua non of the bankruptcy case and which would leave very limited role for general bankruptcy counsel).

Courts remain relatively divided on the plain meaning of “conducting the case.” While the Third Circuit currently permits special counsel to be involved in approval of financing, sales of assets and key employee retention programs, the facts and circumstances of each case can and must be carefully weighed.¹⁷ The term has been recognized, however, to include matters related to formulation of a chapter 11 plan, and/or liquidation of the debtor’s assets.¹⁸

Although it is thus easier to qualify as counsel under section 327(e) than under section 327(a); section 327(e) cannot and should not be perceived as an end run around the retention requirements of section 327(a). Thus, counsel under section 327(e) will not be permitted to serve as special counsel for the purpose of providing general representation to the debtor and the fee applications will tell the story in the event there is a shifting of responsibility during the tenure of the case.

Finally, the requirements of Fed. R. Bankr. P. 2014 are instructive and give teeth to the true intent of 327 (e). The application to employ special counsel under section 327 requires an affidavit signed by counsel, setting forth, among other things, all of counsel’s connections¹⁹ with the parties and professionals in the case. This disclosure is made so that other parties, and the court, can evaluate whether there are any disqualifying conflicts of interest.²⁰ The consequences for incomplete or misleading disclosures may include disqualification and total disgorgement.²¹

¹⁷ See *Woodworkers*, 323 B.R. at 407 (citing the following District of Delaware cases which stand for this proposition : *In re TalkPoint Communications, Inc.*(Bankr.D.Del, 2004); *In re SFMB Acquisition Corp.*, (Bankr.D.Del., 2003); and *In re Troll Communications LLC*, (Bankr.D.Del., 2003).

¹⁸ See *In re Neuman*, 138 B.R. 685 (S.D.N.Y. 1992), citing 2 Collier on Bankruptcy (15th Ed. & 1991 Supp.)(duties of special counsel should not overlap with general counsel’s duty of conducting the case); *In re Interstate Distrib. Ctr. Assocs.*, 137 B.R. 826 (Bankr. D. Colo. 1992)(court denied special counsel’s application to provide the debtor services which included drafting the chapter 11 plan and disclosure statement); *In re Tidewater Mem’l Hosp., Inc.*, 110 B.R. 221, 228 (Bankr. E.D. Va. 1989)(court denied application to employ special counsel where counsel had previously assisted the debtor in the reorganization process, i.e., a sale pursuant to the reorganization); *In re Michigan Interstate Ry. Co., Inc.*, 32 B.R. 627 (Bankr. E.D. Mich. 1983) (court refused to appoint as special counsel a firm which was identified as the debtor’s “reorganization counsel” and which the trustee relied upon for basic legal services); *In re Hempstead Realty Assocs.*, 34 B.R. 624 (Bankr. S.D.N.Y. 1983) (court denied application to retain special counsel for the purpose of providing basic legal advice with respect to the debtor’s powers and duties as a debtor-in-possession, the preparation of applications, answers, orders, reports, and assistance in preparing a plan).

¹⁹ Courts have determined that “connections” include presently existing connections, as well as past connections of a business or personal nature that are either related to the bankruptcy proceeding or could reasonably affect a professional’s judgment in the case. See *Rome v. Braunstein*, 19 F.3d 54, 59 (1st Cir. 1994) (counsel should disclose connections that “reasonably suggest” actual or potential conflicts of interest); *In re Brennan*, 187 B.R. 135 (Bankr. D.N.J. 1995); *In re Marine Outlet, Inc.*, 135 B.R. 154 (Bankr. M.D. Fla. 1991); *In re Rusty Jones, Inc.*, 134 B.R. 321 (Bankr. N.D. Ill. 1991).

²⁰ See *In re Mercury*, 280 B.R. 35, 55-56 (Bankr. S.D.N.Y. 2002).

²¹ See *In re Balco Equities, Ltd* 345 B.R. 87 (Bankr. S.D.N.Y. 2006) (law firm’s failure to disclose its representation of major creditors of bankruptcy debtors under 11 U.S.C.S. § 327 and Fed. R. Bankr. P. 2014 warranted denial of the firm’s fee application, since the firm was not disinterested, was thus ineligible to represent the debtors, and was responsible for its bankruptcy associate’s nondisclosures); *Exco Res., Inc. v. Milbank, Tweed, Hadley & McCloy LLP (In re Enron Corp.)*, 2003 U.S. Dist. LEXIS 1442, 2003 WL 223455 at 4 (S.D.N.Y. Feb 3, 2003) (purpose of Rule 2014(a) is to provide the court and the United States trustee with information to determine whether the professional’s employment is in the best interest of the estate. . . . Rule 2014 disclosures are to be strictly construed and failure to disclose relevant connections is an independent basis for the bankruptcy court to disallow fees or to disqualify the professional from the case); *In re Leslie Fay Cos.*, 175 B.R. at 533 (failure to disclose relevant connections is an independent basis for the disallowance of fees or even disqualification); *In re Granite Partners, L.P.*, 219 B.R. 22, 41 (Bankr. S.D.N.Y. 1998) (failure to disclose is an exacerbating factor warranting the reduction or denial of fees for lack of disinterestedness. . . . “willful or intentional failure to disclose merits the harshest sanctions”); See also *In re Fretter, Inc.*, 219 B.R. 769, 776-777 (Bankr.N.D. Ohio 1998) (endorsing sanctions ranging from total denial of fees to the imposition of economic sanctions).

In the last analysis, whenever attempting to employ or be employed as special 327 (e) counsel in the Third Circuit, it is important to be clear in delineating your duties vis a vis general bankruptcy counsel to ensure that there is no overlap and the work is not tantamount to conducting the debtor's case. Further, it is mandatory to disclose any and all connections in the 2014 affidavit, and to disclose and discuss any potential problems with the parties and the US Trustee's Office ahead of time before they become an issue.

