

“BANKRUPTCY 2008: VIEWS FROM THE BENCH”

**September 12, 2008
Washington, DC**

**ETHICS: CONFLICTS COUNSEL,
DISCLOSURES, THE ROLE OF
LOCAL COUNSEL, AND MORE...**

**GEORGETOWN UNIVERSITY LAW CENTER
CONTINUING LEGAL EDUCATION**

-and-

AMERICAN BANKRUPTCY INSTITUTE

THE PANELISTS

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Alexandria, VA

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¹ The invaluable assistance of Lisa Maria Gonzalo, Summer Associate (Fordham University School of Law, Class of 2009), Day Pitney LLP, is recognized in connection with the research for, and preparation of, these materials.

I. Conflicts Counsel

A. Selected Cases

- (i) *In re Enron Corp.* (Case No. 01-16034) (AJG)) (Conflicts Counsel approved/retained for the Debtors, and for the Official Committee Of Unsecured Creditors), 2002 Bankr. LEXIS 1720 (Bankr. S.D.N.Y. 2002) (Bankruptcy Court denied objection to allowance of fees and expenses for primary Committee counsel, and also denied – in all respects – Motion to disqualify Committee counsel; existence/involvement of conflicts counsel for Committee cited multiple times in conjunction with Court’s decision.)
- (ii) *In re Adelphia Communications Corp.* (Case No. 02-41729(REG)) (Bankr. S.D.N.Y.) (Special Conflicts Counsel for the Bondholders Group)
- (iii) *In re 3dfx Interactive, Inc.* (Case No. 02-55795-RLE) 2007 Bankr. LEXIS 1941 (Bankr. N.D. Cal. June 1, 2007) (Special Conflicts Counsel to the Official Committee of Unsecured Creditors) (counsel disqualified for “adverse interest” resulting from defense of Committee chair in fraudulent conveyance action brought by Chapter 11 trustee)
- (iv) *In re Calpine Corp.* (Case No. 05-60200 (BAL)) (Bankr. S.D.N.Y.) (Special Conflicts Counsel for the Official Committee of Unsecured Creditors)
- (v) *Dana Corporation* (Case No. 06-10354(RDD)) (Bankr. S.D.N.Y.) (Conflicts Counsel for the Debtor)
- (vi) *In re M. Fabrikant & Sons, Inc., et al.* (Case No. 06-12737 (SMB)) (Bankr. S.D.N.Y.) (Conflicts Counsel to the Official Committee of Unsecured Creditors)
- (vii) *In re Werner Holding Co (DE), Inc.*(Case No. 06-10578 (KJC)) (Bankr. D. Del.) (Conflicts Counsel for Official Committee of Unsecured Creditors)

B. Docket Search Results

See attached chart with regard to bankruptcy cases, filed between 2006 and the present, where “conflicts counsel” is identified as being involved.

II. The Game of “Gotcha”

- *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992). Debtor filed a complaint against her employer for alleged race and sex discrimination, and a local government agency found the employer liable but did not calculate damages. While the employer’s appeal to the state’s highest court was pending, the debtor filed a case under Chapter 7. On her Section 522(l) schedule as to claimed exemptions, the debtor claimed the money that she expected to win in her discrimination lawsuit as exempt property. The debtor’s bankruptcy trustee, though considering the potential proceeds of the lawsuit to be property of the bankruptcy estate, did not believe that the lawsuit had any value and decided not to object to the exemption.

Post-petition, debtor’s employer settled the case by agreeing to pay her \$110,000 (she signed over approx. \$71,000 to her attorneys). The Chapter 7 trustee then filed a complaint against the attorneys in Bankruptcy Court, trying to recover the money that they had received from the debtor because he considered it to be property of the debtor’s bankruptcy estate.

The U.S. Supreme Court held that, based upon the “plain” meaning of section 522(l) and Bankruptcy Rule 4003(b), the trustee’s failure to timely object to the debtor’s claimed exemption prevented him from challenging the validity of the exemption, regardless of whether the debtor had a colorable statutory basis for her claim, because:

- (i) although deadlines may lead to unwelcome results, they prompt parties to act and produce finality;
- (ii) if the trustee did not know the value of the lawsuit, he could have sought a hearing on the issue or asked the Bankruptcy Court for an extension of time to object, and he did neither; and
- (iii) to the extent that existing penalties for improper conduct in bankruptcy proceedings did not limit bad-faith claims of exemptions by debtors, Congress may enact new provisions to prevent so-called “exemption by declaration”. However, the Supreme Court had no authority to limit the application of Section 522(l) to exemptions claimed in good faith.

In his dissenting opinion, Justice Stevens -- noting that there is “ample authority to hold that the doctrine of equitable tolling applies to the 30-day limitations period in Federal Rule of Bankruptcy Procedure 4003(b) -- cites, *inter alia*, the decision in *In re Bennett*, 36 B.R. 893 (Bankr. W.D. KY 1984), and states as follows:

There, the court explained that to apply Rule 4003(b) rigidly would be to encourage a debtor to claim all of her property as exempt, thus leaving it to the trustee and creditors to sift through the myriad claimed exemptions to assess their validity. Such a policy would result in reversion to “the law of the streets, with bare possession constituting not nine, but ten, parts of the law; orderly

administration of estates would be replaced by uncertainty and constant litigation if not outright anarchy.” *Id.*, at 895

Id., 503 U.S. at 649.

- ***In re Dinova*, 212 B.R. 437 (B.A.P. 2d Cir. 1997).** In a Chapter 7 case, the debtor failed to attend the meeting of creditors required by 11 U.S.C. § 341(a), although debtor’s attorney did attend. The Bankruptcy Court’s standard Notice of Commencement of Case contained a warning legend, in bold, stating that the failure of debtors to attend the meeting would result in dismissal upon *ex parte* order.

The Chapter 7 trustee moved *ex parte* to dismiss the case due to the debtor’s failure to appear at both the initial, and an adjourned, meeting pursuant under § 707(a), without notifying the debtor’s attorney, and the case was dismissed. Notably, the trustee’s motion was filed before the date of the second adjourned 341 meeting.

The court held that the standard boilerplate notice did not comply with the notice and hearing requirements of § 707(a), because it did not give any party in interest any practical means to oppose a motion to dismiss once the trustee decided to file an *ex parte* motion. In conjunction with its decision, the B.A.P. addressed the issues of “due process” and adequacy of notice. It further stated that a Chapter 7 case may not be dismissed under § 707(a) without serving notice and supporting papers on all parties in interest, an actual hearing or opportunity to be heard, and a finding of “cause” for dismissal.

III. Role and Responsibilities of Local Counsel

A. <http://www.uscourts.gov/rules/bk-localrules.html>

- The role and responsibilities of local counsel are determined by the local rules of each individual District. This website contains hyperlinks to Local Rules for each District.

B. Richard E. Mikels, *Pro Hac Vice: Pro or Con?*, *American Bankruptcy Institute Journal*, 20-10 A.B.I.J. 22 (Dec. 2001/Jan. 2002)

C. Why have local counsel?

- Local Rules may require it. Courts need someone subject to their general control, to be held accountable for improper or unprofessional conduct that may occur. It’s easier for parties to “communicate readily” with counsel within the judicial district.
- Familiarity with judges, and with other professionals involved.

D. Local Bankruptcy Rules vary in the degree of participation required of local counsel:

Extensive responsibility

- ***E.g., District of Delaware Local Bankruptcy Rule 9010-1(a) and (c)*** – Requires extensive involvement in the case, including signing all papers filed with the Bankruptcy Court and appearing at hearings

Fewer responsibilities

- ***E.g., Western District of Illinois Local Bankruptcy Rule 603(C)*** – Requiring local counsel to be responsible for receiving service of notices and pleadings, but specifically not requiring local counsel to “take responsibility for any substantive aspects of the litigation or to sign any pleading, motion, or other paper”
- ***E.g., District of Rhode Island Local Bankruptcy Rule 9010-1(c)*** – Requiring local counsel for representation of debtor or trustee and for representation of any entity in contested matters and adversary proceedings, but silent as to local counsel’s role.

No responsibilities at all

- ***E.g., Northern District of Ohio Local Bankruptcy Rule 2090-1*** – Specifically providing that it is unnecessary to associate with local counsel.

Silent on the Issue

- ***E.g., District of Massachusetts Local Bankruptcy Rules***

E. Provisions in Regional Local Rules and General Orders Addressing Boilerplate Topics²

- **S.D.N.Y. – General Order No. M-274 (Guidelines for Financing Requests)**

Motions seeking DIP financing or use of cash collateral must prominently disclose such things as cross-collateralization, rollups, waivers and concessions as to pre-petition debt, liens on avoidance actions, carve outs, section 506(c) waivers, or termination and default provisions. *See* S.D.N.Y. Gen. Order No. M-274.

- **D.N.J. – General Order Adopting Guidelines for Financing Requests (March 31, 2008)**

Motion seeking DIP financing or use of cash collateral must conspicuously disclose such things as cross-collateralization, rollups, waivers and concessions as to pre-petition debt, liens on avoidance actions, carve outs, section 506(c) waivers, or termination and default provisions.

² Prepared by Mark D. Taylor, Esq., Kilpatrick Stockton, LLP.

- **E.D. PA. – Local Rule 1002-4 (Cash collateral in cases with complex case designation)**

Motions seeking use of cash collateral must disclose in bold face type such things as cross-collateralization, waiver of section 506(c) rights, releases, stay relief, findings regarding amount, perfection, priority, etc. of lender’s pre-petition liens and claims, waiver of avoidance claims, or waiver of state foreclosure provisions.

- **W.D. PA. – General Court Procedure # 10 (Cash collateral)**

Prohibits cross-collateralization, stay relief, releases, stipulation regarding perfection, priority, amount, etc., and time limits on debtor to make such challenges.

- **D. Del. – Local Rule 6004-1 (Sale and sale procedures)**

Motions seeking to sell property or for approval of bid procedures must highlight potentially controversial provisions governing sale and sale procedures, such as sales to insiders or management, releases, sale of avoidance actions, credit bids, qualified bids, break-up fee, or overbid amounts.

- **D. MD. – No similar provisions.**
- **D.D.C. – No similar provisions.**
- **E.D.VA. – No similar provisions.**

F. Selected Cases

- ***Huber v. Taylor*, 469 F.3d 67, 81-82 (3d Cir. 2006)** (holding that Local Counsel’s alleged failure to fulfill the fiduciary duty of disclosure did not excuse defendants, who were the primary plaintiffs’ attorneys for asbestos personal injury claimants).

This matter arose out of asbestos personal injury cases, involving several thousand plaintiffs and 200 defendants. The first round of plaintiffs were awarded \$48 million after trial. This large award prompted many companies to explore settlements, and plaintiffs here (former steelworkers) were part of that group exploring settlements. These plaintiffs retained counsel in their home states to prosecute their asbestos claims, *i.e.*, Local Counsel.

Local Counsel entered into co-counsel agreements with original Lead Counsel who won the first large state court judgment. Local Counsel was to receive 95% of the fees for new asbestos cases. The Third Circuit emphasized that this fee arrangement was key, since Local Counsel would only profit in volume, and only got 2% of whatever their clients recovered. This gave little incentive for Local Counsel to focus on any particular case.

Plaintiffs alleged that Defendants (*i.e.*, Lead Counsel) breached their fiduciary duties of undivided loyalty and candor, claiming that:

- (i) Defendants owed them a fiduciary duty as their counsel;

- (ii) Defendants engaged in undisclosed, multiple representations;
- (iii) Defendants had a conflict of interest regarding their multiple representations because of the fee arrangements that gave Defendants a larger percentage of Southerners' recoveries than of Northerners' and that this created an incentive for Defendants to negotiate settlements that paid more for Southerners' claims than for Northerners';
- (iv) Defendants never gave proper disclosure of this conflict of interest or of the full terms of the settlement offers

Defendants argued that they did not have a fiduciary duty of disclosure, because this duty was assumed by Local Counsel.

The Third Circuit held that the fiduciary duty owed clients is an obligation that is jointly shared by and between all co-counsel, and cannot be delegated. "It is well-settled law, regardless of jurisdiction, that attorneys owe their clients a fiduciary duty . . . If Local Counsel did not perform their fiduciary duty, it does not matter [to Lead Counsel's liability for breach of fiduciary duty] that they assumed the duty because the *fiduciary duty of co-counsel is a joint obligation*. Even if the duty of disclosure is itself delegable, the duty of loyalty is inherently not, and in this case disclosure was necessary to fulfill the duty of loyalty." *Id.* at 81-82 (emphasis added).

All attorneys in a co-counsel relationship individually owe each and every client the duty of loyalty. For it to be otherwise is "inconceivable". There is no question that Defendants owed Plaintiffs fiduciary duties.

- ***Ingemi v. Pelino & Lentz*, 866 F. Supp. 156 (D.N.J. 1994)**. On a pretrial motion in a malpractice suit against "related" New Jersey and Pennsylvania law firms, the New Jersey firm claimed that it was an improper defendant since any potential liability would be "narrowly circumscribed" due to its role as local counsel. The New Jersey law firm was retained as local counsel, and then petitioned the court to admit *pro hac vice* two lawyers from the Pennsylvania firm. The New Jersey firm argued that one of the Pennsylvania lawyers was the only one to give advice and act "on the judgmental and strategic issues," and contended that the New Jersey firm served "merely" as local counsel, performed ministerial tasks, and undertook "discovery and motion practice in a manner that did not require making judgments or giving advice regarding prejudgment remedies or settlements."

HELD: The U.S. District of New Jersey found that the New Jersey firm "underestimate[d] the role of local counsel" and stated that "by virtue of submitting the *pro hac vice* application, [the New Jersey firm] was responsible for the 'conduct of the cause.'" Local court rules "require local counsel to take more than a *de minimis* role in the representation," and clearly indicate "that local counsel is the counsel of record with attendant responsibilities, not out-of-state counsel admitted *pro hac vice*."

The Court held that “[l]ocal counsel must also supervise the conduct of pro hac vice attorneys and must appear before the court in all proceedings.... Even if pro hac vice attorneys attempt to delegate solely routine or ministerial tasks to local counsel, local counsel remains counsel of record and wittingly or unwittingly exposes itself to liability for penalties such as sanctions.”

The Court also held that, even if the New Jersey firm’s role in the underlying litigation was insignificant, “this court is left wondering whether the New Jersey firm adequately supervised the work of the Pennsylvania firm’s employees, as required by New Jersey practice rules and whether a New Jersey plaintiff’s legal interests were safeguarded.”

G. BNA/ABA Lawyers Manual on Professional Conduct, 21:2015, 21:2016

Responsibilities of Local Counsel

- Normally required under pro hac vice rules, but a lawyer handling a nonlitigated matter may wish to associate with local counsel to ...
 - (i) avoid entanglement with unauthorized practice laws, or
 - (ii) work with someone who is familiar with local rules and practices.
- The precise role of local counsel varies, depending on the jurisdiction and on factors such as whether the matter is pending before a court.
- *Compare Dorador v. State, 573 P.2d 839* (Wyo. 1978) (construing pro hac vice rule requiring association with local counsel, court stated that “[t]he function of local counsel is something more than a matter of form or protocol; it is not intended that he be only a figurehead. It is expected that he take an active part in the representation of the client concerned and be available to share responsibility as well as actively participate in the case at hand, in the absence of out-of-state counsel”), *with*
- **Local Rule 83.15 of the U.S. District Court for the Northern District of Illinois** (local counsel not required “to handle any substantive aspects of the litigation” or “to sign any pleading, motion or other paper”).
- Whatever the involvement of local counsel in the representation, that “local” lawyer may be held responsible for the actions of the out-of-state attorneys with whom local counsel has associated. Local counsel may be subject to contempt, trial conduct sanctions and malpractice liability, and also faces the prospect of disciplinary action under ethics rules on lawyers’ supervisory responsibilities.

Sanctions

- For purposes of contempt charges or violations of Fed. R. Civ. P. 11 (having to do with misrepresentations by counsel to the court) or its state counterparts, courts have often found local counsel to be just as responsible for misconduct as out-of-state lead counsel.

- *E.g., Val-Land Farms Inc. v. Third National Bank in Knoxville*, 937 F.2d 1110 (6th Cir. 1991) (local counsel subject to Rule 11 sanctions, notwithstanding that they may have signed complaint in reliance on material submitted by outside counsel, who actually litigated case; “[t]he text of the rule does not provide a safe harbor for lawyers who rely on the representations of outside counsel”);
- *Itel Containers Int’l Corp. v. Puerto Rico Marine Management Inc.*, 108 F.R.D. 96 1985 (NOTE: Apparently two different decisions using this citation.), U.S. Dist. LEXIS 14481 (D.N.J. 1985) (local counsel subject to Rule 11 sanctions to same extent as foreign counsel for joining in foreign lawyers’ strategy of actively concealing court’s lack of subject matter jurisdiction);
- *Long v. Quantex Resources Inc.*, 108 F.R.D. 416, 417 (S.D.N.Y. 1985) (local counsel who signed motions and presented them to court held subject to sanctions under Rule 11, even though papers apparently were prepared by foreign “primary” counsel)(“[A]t the very least, a local counsel that signs the papers of foreign counsel must read the papers, and from that have a basis for a good faith belief that the papers on their face appear to be warranted by the facts asserted and legal arguments made, and are not interposed for any improper purpose.”);
- *Lewis v. Celina Financial Corp.*, 655 N.E.2d 1333 (Ohio 1995) (local counsel subject to sanctions under Rule 11, F.R.Civ.P., while his firm was liable under Ohio’s version of Rule 11, notwithstanding lawyer’s asserted reliance on outside lawyer who forwarded complaint for filing);
- *In re Palafox*, 673 P.2d 1296 (N.M. 1983) (both out-of-state and local counsel held in contempt for failure to comply with rule regarding out-of-state lawyers and rule requiring trial counsel to prepare docketing statement for appeal).
- *But see, CTC Imports & Exports v. Nigerian Petroleum Corp.*, 951 F.2d 573 (3d Cir. 1991) (Rule 11 sanctions not warranted where, at time complaint was filed, local counsel was not in position to know or obtain vital information);
- **Local Rule 83.15, U.S. District Court for the Northern District of Illinois** (local counsel not required “to handle any *substantive* aspects of the litigation” or “to sign any pleading, motion or other paper”); *cf.*, *First Interstate Bank of Denver, N.A. v. Estates Partnership*, 117 F.R.D. 683 (D. Colo. 1987) (lawyers who sought admission of out-of-state attorney without revealing attorney’s criminal and disciplinary record, as required by rules, subjected to sanctions under Rule 11).

Malpractice

- The association between local and out-of-state counsel may also create the possibility of malpractice liability.
- *See, e.g., Ingemi v. Pelino & Lentz*, 866 F. Supp. 156 (D.N.J. 1994) (rejecting local counsel’s attempt to be dismissed as malpractice defendant on basis that it had only

ministerial role in underlying litigation; court rules “require local counsel to take more than a de minimis role in the representation”);

- **Scott v. Francis, 838 P.2d 596 (Or. 1992)** (local lawyer may be required to indemnify foreign lawyer for liability to client if foreign lawyer’s delay in filing client’s action was due solely to reliance on local lawyer’s misrepresentation on time for filing);
- **But see, Macawber Engineering Inc. v. Robson & Miller, 47 F.3d 253, 257 (8th Cir. 1995)** (local counsel had no duty under Minnesota U.S. District Court Local Rule to monitor lead counsel’s handling of discovery process);
- **Ortiz v. Barrett, 278 S.E.2d 833 (Va. 1981)** (local counsel had no duty to file appeal over objection of foreign counsel, who was lead counsel in case).

Duty to Supervise

- Lawyers acting as local counsel may have a duty to supervise the work of out-of-state attorneys, and may ultimately be held responsible for the out-of-state attorneys’ misconduct. *See, e.g.*, Arizona Ethics Op. 96-06 (1996) (lawyer supervising out-of-state lawyer-employee who is awaiting admission to local bar is ultimately responsible for work performed by out-of-state lawyer, including adherence to ethics rules; supervising lawyer must ensure that foreign lawyer does not engage in unauthorized practice);
- Georgia Ethics Op. 98-1 (1998) (Georgia attorney serving as local counsel for out-of-state lawyer admitted pro hac vice may be disciplined for discovery abuses committed by out-of-state lawyer if attorney knows of abuses and ratifies them, or if attorney has supervisory authority over out-of-state lawyer); cf.
- Connecticut Informal Ethics Op. 99-2 (1999) (partnership between out-of-state law firm and Connecticut firm may continue to maintain office in state when firm’s sole Connecticut partner relocates to another state, provided partners adequately supervise associate lawyers and paralegals and Connecticut partner maintains Connecticut license; opinion noted “logistical difficulties” in maintaining adequate supervision);
- Utah Ethics Op. 96-14 (1997) (Utah lawyers may form partnerships and share fees with out-of-state lawyers, but out-of-state lawyers are subject to prohibitions against unauthorized practice of law and all local legal services must be provided by or under direct supervision of Utah lawyers).

IV. Lawyer as a Member of the Creditors’ Committee

- A. Where the lawyer sits as a representative of his firm, in his role as creditor of the debtor (MONEY OWED TO LAW FIRM)
- B. Where the lawyer sits on the Committee, and participates as the representative of the creditor (MONEY OWED TO CREDITOR)

C. The ability of a lawyer/law firm that is a Committee member to be retained as Section 327(e) counsel for the debtor (SPECIAL COUNSEL)

- ***In re Buffalo Coal Co., 2008 Bankr. LEXIS 1259 (Bankr. N.D. W. Va. April 30, 2008).*** Chapter 7 trustee sought to retain Law Firm for the limited purpose of suing VEPCO. While the case was under Chapter 11, Law Firm represented the creditors' committee. VEPCO was a member of the committee. Several parties objected to the retention of Law Firm, for the purpose of suing VEPCO, because of this relationship. The Court allowed the trustee to retain the Law Firm, finding that its representation of the creditors' committee was not tantamount to representation of VEPCO. The court also said that any information Law Firm may have obtained from VEPCO while representing the creditors' committee would eventually come to light in the case between the debtor and VEPCO.

ALSO...

- ***In re Contractor Tech., Ltd., 2006 U.S. Dist. LEXIS 34466 (S.D. Tex. May 30, 2006).*** This was a Chapter 7 case where the trustee sought to hire Law Firm as special litigation counsel, on a contingency basis, to investigate and prosecute avoidance claims against various creditors. Law Firm represented eight of the creditors of the debtor. For that reason, the largest creditor of the estate objected to the hiring of Law Firm. The bankruptcy judge approved the retention of the Law Firm, but provided that Law Firm was not to be involved in investigating or prosecuting avoidance claims against any of its eight clients; the trustee could use general bankruptcy counsel or retain other counsel with respect to these eight creditors, as well as with respect to claims that Law Firm and the debtor's financial advisor did not pursue. The record also reflected that, with near certainty, no post-petition payments had been made to any of the Law Firm's eight clients. On appeal the District Judge sustained the Bankruptcy Judge's order, holding that Law Firm had no "actual" conflict of interest and that it was disinterested; "concern about potential issue conflicts or the "appearance of a conflict" [was] ... legally insufficient to warrant disqualification..." *Id.* at 29.

V. Attorney-Client Privilege Issues

A corporate debtor's attorney-client privilege
transfers to (or can be waived by) a bankruptcy trustee

- ***Commodity Futures Trading Commission v. Weintraub, 471 U.S. 343 (1985).*** The Commodity Futures Trading Commission launched a formal investigation to determine whether a discount commodity brokerage corporation had violated the Commodity Exchange Act. On the same day that the Commission filed a complaint against the corporation, the sole director and officer of the corporation entered into a consent decree with the Commission, which provided for the appointment of a receiver and for the receiver to file a petition for liquidation. The receiver was later appointed as trustee in the corporation's bankruptcy case. The Commission subsequently served a subpoena upon the corporation's former counsel who, at deposition, refused to answer certain questions, asserting the corporation's attorney-client privilege. In response to the Commission's request, the bankruptcy trustee waived any interest he had in the attorney-client privilege

possessed by the corporation for any communications or information occurring or arising on or before the date of his appointment as receiver.

- The U.S. Supreme Court held that the trustee of a corporation in bankruptcy has the power to waive the corporation's attorney-client privilege with respect to communications that took place before the filing of the petition in bankruptcy. In so ruling, however, the U.S. Supreme Court pointedly stated that "our holding today had no bearing on the problem of individual bankruptcy, which we have no reason to address in this case...." *Id.*, at 356

- Courts have since addressed this issue in one of three ways:

- (i) Some courts hold that per se an individual's attorney-client privilege as to pre-petition communications does not automatically pass to the trustee...

In re Hunt, 153 B.R. 445, 451 (Bankr. N.D. Tex. 1992) (absent a specific agreement among the *parties*, at least in the context of a plan of reorganization where the trustee succeeded to certain rights and property of the debtors, the trustee could not step into debtors' shoes and direct counsel to waive the privilege on their behalf);

In re Silvio De Lindegg Ocean Dev., Inc., 27 B.R. 28 (Bankr. S.D. Fla. 1982); *In re Tippy Togs of Miami, Inc.*, 237 B.R. 236, 239 (Bankr. S.D. Fla. 1999) (when an individual, who is also the principal of a corporation, seeks personal legal advice, the privilege can not be waived by the corporation, or its bankruptcy trustee, merely because corporate *matters* are also discussed, even when the attorney is ultimately retained to represent the corporation.)

- (ii) Some Courts hold that an *individual's* attorney-client privilege as to pre-petition communications always passes to the trustee, by operation of law.

E.g., *In re Smith*, 24 B.R. 3, 5 (Bankr. S.D. Fla. 1982)

- (iii) The apparently more common approach that courts tend to apply is a balancing test, where an individual debtor's attorney-client privilege as to pre-petition communications transfers to the trustee when, on balance, the trustee's duties to maximize the value of the estate outweigh the policies underlying the attorney-client privilege and the harm to the debtor of disclosure.

Foster v. Hill (In re Foster), 188 F.3d 1259, 1266 (10th Cir. 1999)

Whyte v. Williams (In re Williams), 152 B.R. 123, 129 (Bankr. N.D. Tex. 1992)

Moore v. Eason (In re Bazemore), 216 B.R. 1020, 1024 (Bankr. S.D. Ga. 1998)

Ramette v. Bame (In re Bame), 251 B.R. 367, 377 (Bankr. D. Minn. 2000)

French v. Miller (In re Miller), 247 B.R. 704, 709 (Bankr. N.D. Ohio 2000)

In re Pearlman, 381 B.R. 903, 908 (Bankr. M.D. Fla. 2007)

Other interesting attorney-client privilege problems in the context of bankruptcy cases

- ***Official Comm. of Unsecured Creditors v. Fleet Retail Fin. Group (In re Hechinger Investment Company of Delaware)*, 285 B.R. 601 (D. Del. 2002).** Debtor filed for Chapter 11. Subsequently, “replacement” counsel for the debtor wrote to the debtor’s former counsel requesting that all documents in counsel’s possession relating to their prior representation of the debtor be turned over, relying on bankruptcy law, including 11 U.S.C. § 542(e). The debtor’s former counsel refused to produce all the documents requested, invoking the attorney-client privilege and/or attorney work product privilege, and took the position that only the debtor’s former officers and directors, and not the Liquidating Trust established pursuant to the Debtors’ confirmed Plan of Liquidation, controlled the privilege. The Trust responded that the debtor’s former officers and directors had no continuing right to assert a privilege over the debtor’s documents and filed a motion to compel former counsel to turn over privileged documents. The Delaware District Court agreed with the Trust, finding that the reliance of former counsel and the former directors, officers and shareholders of the Debtors on *Tekni-Plex v. Meyner & Landis*, 89 N.Y. 2d 123, 674 N.E. 2d 663 (N.Y. 1996) was misplaced, and that the decision was clearly distinguishable from the present matter. The District Court thus found that the power to exercise the attorney-client privilege in bankruptcy proceedings had passed to the Trust. The Court therefore directed the debtor’s former officers and directors and/or their counsel to produce the files at issue to all parties in the litigation.
- ***SonicBlue Claims LLC v. Portside Growth and Opportunity Fund (In re SONICblue Incorporated)*, 2008 Bankr. LEXIS 181 (Bankr. N.D. Cal. Jan. 18, 2008).** SonicBlue Claims LLC (“SBClaims”), a claims trader which had previously purchased a number of claims against the debtor, moved to compel production of documents from debtor’s former counsel (*i.e.*, Pillsbury Winthrop Shaw Pittman, LLP (“PWSP”)), which firm had previously been disqualified from representing the debtor due to undisclosed conflicts arising from their issuance of a pre-petition opinion letter to various noteholders of the debtor and other related matters. (NOTE: The documents were sought by SBClaims in conjunction with their adversary proceeding against certain noteholders for equitable subordination and reclassification of their claim, and also seeking a declaration that a claim which they had acquired was entitled to “Senior Indebtedness” status.) The subsequently appointed Chapter 11 trustee for the debtor filed a statement in support of SBClaims’ Motion, and waived the debtor’s privileges for the period of time before his appointment.

As former counsel for the debtor, PWSP argued that some 435 communications with its in-house counsel concerning the firm’s ethical duties to SONICblue were protected by its own attorney-client privilege and work product doctrine. The Court ruled that PWSP could not shield its communications with their own in-house counsel after its conflict of interest became apparent. Its fiduciary duties prohibited it from engaging in any activity adverse to the debtor’s interests. In conjunction with this ruling, the Bankruptcy Court stated, *inter alia*, as follows:

[W]hen a law firm chooses to represent itself, it runs the risk that the representation may create an impermissible

conflict of interest with one or more of its current clients. In light of these ethical concerns, the courts that have considered the issue have resoundingly found that, where conflicting duties exist, the law firm's right to claim privilege must give way to the interest in protecting current clients who may be harmed by the conflict.... [(Citations omitted.)] As a result, a law firm cannot assert the attorney-client privilege against a current outside client when the communications that it seeks to protect arise out of self-representation that creates and impermissible conflicting relationship with that outside client [(*Id.*, at *26.)]

PWSP was therefore directed to produce all documents for which it claimed either attorney-client or work product privilege.

VI. The Committee Lawyer Who Previously Represented a Creditor of the Debtor

- ***In re Matco Electronics Group, Inc.*, 2008 WL 141908 (Bankr. N.D.N.Y. Jan. 11, 2008).** In an application to be retained as counsel to the official creditors' committee, the attorney to be primarily responsible for the case failed to disclose that Douglas Spelfogel ("Spelfogel"), one of the firm's attorneys, was the son-in-law of the CEO and President of a major creditor of the debtor's estate that was also a petitioning creditor and active member of the Committee. Some time thereafter, Spelfogel's wife became in-house counsel to that same creditor. As a result of the failure to disclose these "connections" -- the Court found the disclosures that were made to be "purposefully vague" -- the Court, in ruling on the law firm's final fee application, only allowed one-half of fees that had previously been the subject of a holdback and denied the balance of the fees sought in the firm's fee application.

Notably, as part of its decision, the Bankruptcy Court stated that "Fed.R.Bankr.P. 2014 is not intended to condone a game of cat and mouse where the professional seeking appointment provides only enough disclosure to whet the appetite of the UST, the court or other parties [in] interest, and then the burden shifts to those entities to make inquiry in an effort to expand the disclosure... [(Citations omitted.)]" The Court further observed that, while Spelfogel's relationship to the creditor "may not have created a per se conflict of interest at the time of ... [his law firm's] appointment, subsequent developments in these cases suggest that it may have created an atmosphere of hostility between the Committee and the Debtors that ultimately led to another member of the Committee... moving on two occasions for an order removing Spelfogel and ... [his successor firm] as Committee counsel... ." The Court further noted that certain litigation "against the Committee, as well as its individual members, alleging serious transgressions by Spelfogel and ... [his successor firm] in their representation of the Committee..." were resolved with "relative ease" once Spelfogel and his firm exited. Therefore, it conjectured that, had a more detailed disclosure been made in the initial retention affidavit three years earlier, the Court might have been reluctant to appoint Spelfogel's firm in the first place, thus avoiding the very problems that subsequently developed.

- *In re Meridian Automotive Systems – Composite Operations, Inc.*, 340 B.R. 740 (Bankr. D. Del. 2006).³ This case arose in the context of Stanfield Capital Partners, LLC (“Stanfield”) challenging the right of a law firm to represent an Informal Committee of First Lien Lenders in a Chapter 11 bankruptcy case when, prior to the bankruptcy, that same law firm had previously represented Stanfield, individually, with respect to the same debt at issue in this case. Stanfield’s debt was secured, in part, by a first lien in the Debtors’ assets and also by a second lien in such assets.

In October 2004, Stanfield hired Milbank, Tweed, Hadley & McCloy LLP (“Milbank”) to analyze the credit agreement related to the debt owed by Meridian, as well as the intercreditor agreement between the first and second lenders, in order to identify provisions of the documents that might affect the second lien holders’ plan to provide additional financing to the Debtors to be secured by first priority liens in accounts receivable. In April 2005, the Debtors obtained a commitment for debtor-in-possession financing in anticipation of the Chapter 11 filing. An informal committee of holders of first lien debt (“Committee”) was formed because some of the first lien holders, like Stanfield, also held second lien debt. The informal committee retained Milbank to advise it with respect to intercreditor issues that might arise if the take-out facility was not approved by the court.

The Debtors filed the Chapter 11 petition on April 26, 2005, and thereafter, the court approved the take-out facility on an interim basis. When the Debtors were unable to meet the requirements of the take-out facility to obtain their final approval, the Debtor sought and obtained approval from the court for alternate financing that primed and left intact both tranches of pre-petition secured debt. Milbank thereafter continued to represent the Committee on intercreditor issues. Almost ten months later, on February 13, 2006, Stanfield filed a motion seeking to disqualify Milbank for violating Rule 7.1 of the Delaware Lawyers’ Rules of Professional Conduct.

The initial issue before the court was whether it had jurisdiction to address the merits of the motion, *i.e.*, alleged violations of disciplinary and ethical rules. The court had no difficulty in ruling that its core jurisdiction under 28 U.S.C. § 157(b)(2)(A) included, as one of its inherent powers, “the admissions and discipline of attorneys practicing before it.” Moreover, the court stated, in reliance on *In re Johore Inv. Co.*, 157 B.R. 671, 674 (D. Haw. 1985):

[A] motion to disqualify counsel of a major secured creditor is a matter integrally tied to the administration of the estate, and disposing of such a motion is clearly a necessary function of the bankruptcy judge in presiding over the orderly administration of the estate.

The court also relied on Model Rules of Professional Conduct of the American Bar Association (“Model Rules”), governing the practice of law before the Delaware bankruptcy court, in taking jurisdiction. See, Del. Bankr. L.R. 1001-1(b) (adopting Local Rules for

³ Previously prepared and copyrighted by Richard M. Meth, Esq. (Day Pitney, LLP) and Judith Greenstone Miller, Esq. (Jaffe Raitt Heuer & Weiss, P.C.)

Civil Practice and Procedure of the United States District Court of Delaware); D. Del. L.R. 83.6(d)(2) (incorporating the Model Rules). The rules provide, among other things, that an attorney “may . . . be reprimanded or subjected to other such disciplinary action as circumstances may warrant.” D. Del. L.R. 83.6(d)(1).

Stanfield contended that Milbank had violated two of the Model Rules – Rule 1.7(a) and Rule 1.9 – by undertaking the representation of the Committee. Rule 1.7(a) of the Model Rules provides that “a lawyer shall not represent a client if the representation of . . . [that] client will be directly adverse to another client.” Rule 1.9 provides that:

A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person’s interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.

In this case, Stanfield contended that (i) Milbank still represented Stanfield because it had never terminated their engagement and Milbank had never withdrawn from the representation, and thus it created “a concurrent conflict of interest” prohibited by Model Rule 1.7, and (ii) the issues for which Stanfield retained Milbank were the same issues that were materially adverse to Stanfield and on which Milbank was representing the Committee and on which Milbank did not seek Stanfield’s consent (nor was written consent given by Stanfield) both in violation of Model Rule 1.9.

The court held that Model Rule 1.7 was not applicable because Stanfield had terminated Milbank almost two months before Milbank undertook the representation of the Committee. While no formal termination letter was transmitted by Milbank to support this position, the court, nevertheless, relied on a series of emails that made clear, according to the court, that Stanfield no longer was interested in retaining Milbank in the Meridian case.

With respect to Model Rule 1.9, the court found that Milbank had violated this rule by failing to seek Stanfield’s “informed consent, confirmed in writing” prior to undertaking the representation of the Committee. While Milbank conceded that the interests of Stanfield and the Committee were adverse and that it did not seek Stanfield’s consent to represent the Committee, it argued that (i) the representations did not concern “the same or substantially related matters,” and (ii) Stanfield implicitly consented to Milbank’s representation of the Committee when it terminated Milbank and by failing to bring the conflict to Milbank’s attention within a reasonable period of time.

In finding that the matters for which Stanfield and the Committee both retained Milbank were “the same or substantially related,” the court analyzed the nature of the matters for which Milbank was retained in each engagement in relation to Comment 2 of Model Rule 1.9, which provides, in relevant part, as follows:

The scope of a “matter” . . . depends on the facts of a particular situation or transaction. The lawyer’s

involvement in a matter can also be a question of degree. When a lawyer has been directly involved in a specific transaction, subsequent representation of other clients with materially adverse interests in that transaction clearly is prohibited. . . . The underlying question is whether the lawyer was so involved in the matter that the subsequent representation can be justly regarded as a changing of sides in the matter in question.

In order to distinguish the “matters,” Milbank argued that the purpose for which Stanfield hired Milbank was with respect to a “discrete refinancing transaction (the accounts receivable facility) that was mooted by the Debtors’ bankruptcy filing.” Because the representations were factually distinct, Milbank argued, it did not change sides. The court disagreed, however, and characterized Milbank’s representation as much broader – “the ultimate goal [of Stanfield] was to protect its second-lien position.” Moreover, the court found that the actual work done by Milbank for Stanfield in this regard reflected the broad scope of the engagement, including, but not limited to, the same intercreditor issues on which it was now advising the Committee.

Milbank next argued that, because the sole purpose of Model Rule 1.9 is to protect client confidences and it did not receive any confidential information from Stanfield, it did not breach this rule. The court disagreed, indicating: “While the risk of a breach of client confidences is a *sufficient* condition for “relatedness,” it is not a *necessary* one.” Model Rule 1.9 uses the word “or” – if the matter involves the same transaction or legal dispute *or* there is a risk that confidential information will materially advance a client’s position in a subsequent matter, the rule is implicated.

The court also delved into the underpinnings of Model Rule 1.9. According to the court, Model Rule 1.9 has three distinct purposes: (i) to prevent against even the potential that a former client’s confidences and secrets may be used against him; (ii) to maintain the public’s confidence in the integrity of the bar; and (iii) the client’s right to expect loyalty of the attorney in the matter for which he is retained. Because Milbank represented both Stanfield and the Committee with respect to the same loan documents, the court found that such dual representations raised duty of loyalty concerns sufficient, alone, to support a violation of Model Rule 1.9.

The court refused to accept Milbank’s contention that it did not possess “confidential information” based on not having “received” such information from Stanfield. According to the court, Milbank’s limited and restricted interpretation of “confidential information” was not consistent with Model Rule 1.6, Comment 3, which provides: “The duty of confidentiality “applies not only to matter communicated in confidence by the client, but also to *all information* relating to the representation, *whatever its source.*” *Id.* (Emphasis added). The confidential information at issue in this case, according to the court, was not limited to what Stanfield told Milbank, but also included was Milbank’s own legal conclusions and advice given to Stanfield about the credit documents. Further, the fact that none of the attorneys who had worked for Stanfield were involved in representing the

Committee was also held to be irrelevant because Model Rule 3.1.10 imputes the conflict of one attorney to the entire firm.

Having thus found that Model Rule 1.9 was implicated, Milbank needed to have obtained Stanfield's consent in order to have represented the Committee. To obtain "informed consent" in compliance with Model Rule 1.9(a) requires "the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of action." However, the rules do not require a lawyer "to inform [the] client . . . of facts or implications already known to the client." Model Rule 1.0(e) and Comment 6.

Milbank argued that (i) Stanfield had expressly consented to its representation of the Committee when it terminated Milbank, and (ii) based on Stanfield's "substantial experience in bankruptcy," it "understood the implications" of Milbank's comments (*i.e.*, it was getting calls about the Debtors' cases and had "decided to move on") which, in essence, amounted to consent by Stanfield to Milbank's retention by others in these cases. Second, Milbank argued that Stanfield implicitly consented to Milbank's representation of the Committee by failing to bring the alleged conflict to Milbank's attention within a reasonable time. Milbank also relied on Model Rule 1.0(e), Comment 7 that provides informed consent "may be inferred . . . from the conduct of a client . . . who has reasonably adequate information about the matter." *Id.* Third, Milbank argued that Stanfield waived its right to seek disqualification of Milbank by waiting eight months after learning that Milbank refused to withdraw to bring the Motion. The court dismissed each of Milbank's arguments.

First, the court held that Stanfield did not expressly consent to Milbank's representation of the Committee. Terminating the attorney-client relationship was not equivalent to consenting to Milbank representing another party adverse to Stanfield on the same intercreditor issues. Moreover, at that time, Milbank was not in a position to fully advise Stanfield and seek its consent because the Committee had not yet been formed, nor had Milbank been contacted to represent the Committee.

Second, Milbank violated Model Rule 1.9 because it had already undertaken the representation of the Committee when Stanfield found out about this representation and could have raised the issue. Further, the court found that Stanfield did notify Milbank of the conflict within a reasonable period of time – its general counsel had telephoned Milbank in June 2005 to voice its concern that Milbank's representation of the Committee was inappropriate. At that time, Milbank took the position that the matters were "basically unrelated," and thus, Stanfield's consent was not needed. Thus, the fact that Stanfield didn't raise the issue earlier would not have created a different result. Moreover, the full conflict did not ripen until the take-out facility collapsed, and therefore, it was not unreasonable for Stanfield to wait to raise the issue at that time. The court also dismissed Milbank's contention that Stanfield's failure to object to the Final DIP Order that provided for payment of Milbank's fees and expenses to the Committee constituted "implied consent" because the order did not qualify as a "confirmatory writing" and was neither "given by" Stanfield, nor "transmitted by" Milbank, as required by Model Rule 1.9. Furthermore, the order did not raise or provide any consent to the proposed conflict of interest.

Third, the court dismissed Milbank’s argument that Stanfield had waived the alleged conflict by waiting to bring the issue before the court as being “purely tactical, designed to deprive the . . . [Committee] of its counsel of choice at a crucial point in these cases.” The court was less concerned with Stanfield’s motive than with Milbank’s conduct. After focusing on the importance of the ethical and disclosure rules and recognizing the court’s power to *sua sponte* enforce them, the court found that Stanfield did not waive the conflict because it had continued to insist that a conflict existed.

Finally, Milbank argued that it should not be disqualified based on its reliance in good faith on the opinion of the chair of its Risk Management Committee that no conflict existed. The court found that the reliance was misplaced because Milbank had failed to adequately and fully disclose the facts attendant to the matter in seeking the advice of its conflicts counsel. Milbank then suggested that the Committee would be prejudiced if Milbank were disqualified and that such prejudice outweighed any prejudice to Stanfield. The court, nevertheless, held as there is no absolute right to retain a particular counsel and concluded, based on Milbank’s violation of Model Rule 1.9 and its “dogged refusal to acknowledge the same, warrant[ed] disqualification . . . [of Milbank] from further representation of the . . . [Committee] in these cases.”

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Milbank appealed the decision of Judge Walrath to the United States District Court for the District of Delaware. The appeal was subsequently dismissed, with prejudice, upon Stipulation of Millbank and Stanfield, dated October 18, 2006..

**SCHEDULE OF CASES FILED BETWEEN 2006
AND MAY, 2008 INVOLVING CONFLICTS COUNSEL**

RANK	CASE NUMBER	CASE TITLE	FILING DATE	BANKRUPTCY COURT	CHAPTER
1.	07-10942	In Re: Alliance Bancorp	07/13/2007	Delaware	7
2.	07-10943	In Re: Alliance Bancorp, Inc.	07/13/2007	Delaware	7
3.	07-11047	In Re: American Home Mortgage Holdings, Inc.	08/06/2007	Delaware	11
4.	07-10739	In Re: Amp'd Mobile, Inc.	06/01/2007	Delaware	11
5.	06-22306	In Re: Bayou Group, LLC	05/30/2006	NY Southern District	11
6.	06-10552	In Re: Curative Health Services, Inc.	03/27/2006	NY Southern District	11
7.	06-10354	In Re: Dana Corporation	03/03/2006	NY Southern District	11
8.	06-30400	In Re: David P Newell, Cheryl D Newell	09/19/2006	Northern District of NY	11
9.	08-10375	In Re: DJK Residential LLC	02/05/2008	NY Southern District	11
10.	06-11202	In Re: Dura Automotive Systems, Inc.	10/30/2006	Delaware	11
11.	07-11176	In Re: Fedders North America, Inc.	08/22/2007	Delaware	11
12.	07-01578	In Re: First Magnus Financial Corporation	08/21/2007	Arizona	11
13.	08-10353	In Re: Fortunoff Fine Jewelry And Silverware, LLC	02/04/2008	NY Southern District	11
14.	08-11298	In Re: Frontier Airlines Holdings, Inc.	04/10/2008	NY Southern District	11
15.	06-10152	In Re: G+G Retail, Inc.	01/25/2006	NY Southern District	11
16.	06-10082	In Re: Galvex Capital, LLC	01/17/2006	NY Southern District	11
17.	06-11457	In Re: Home Products International, Inc, Home Products International - North America, Inc.	12/20/2006	Delaware	11
18.	06-25613	In Re: K. W. Muth Company, Inc	10/06/2006	Eastern District of WI	11
19.	07-00761	In Re: Louis J Pearlman	03/01/2007	Middle District of FL	11
20.	06-12737	In Re: M. Fabrikant & Sons, Inc.	11/17/2006	NY Southern District	11
21.	07-13059	In Re: Mila Inc.	07/02/2007	Western District of WA	11
22.	06-10064	In Re: Musicland Holding Corp.	01/12/2006	NY Southern District	11
23.	06-25609	In Re: Muth Mirror Systems, LLC	10/06/2006	Eastern District of WI	11
24.	07-21631	In Re: Nathan And Miriam Barnert Memorial Hospital Association	08/15/2007	New Jersey	11
25.	06-10872	In Re: Neoplan USA Corporation	08/17/2006	Delaware	11
26.	06-10578	In Re: Old Ladder Co. (De), Inc.	06/12/2006	Delaware	11
27.	06-10489	In Re: Oneida Ltd.	03/19/2006	NY Southern District	11
28.	08-10223	In Re: Petro Ventures, Inc.	01/18/2008	Southern District of OH	11
29.	07-13532	In Re: Plvtz, Inc.	11/08/2007	NY Southern District	11
30.	08-10239	In Re: PRC, LLC	01/23/2008	NY Southern District	11
31.	08-10152	In Re: Quebecor World (USA) Inc.	01/21/2008	NY Southern District	11
32.	06-10894	In Re: Radnor Holdings Corporation	08/21/2006	Delaware	11
33.	07-11906	In Re: Ritchie Risk-Linked Strategies Trading (Ireland), Ltd.	06/20/2007	NY Southern District	11
34.	07-14890	In Re: Rockaway Bedding, Inc.	04/09/2007	New Jersey	11

RANK	CASE NUMBER	CASE TITLE	FILING DATE	BANKRUPTCY COURT	CHAPTER
35.	07-50735	In Re: Samaritan Alliance, LLC	04/16/2007	Eastern District of KY	11
36.	06-11868	In Re: Satelites Mexicanos, S.A. De C.V	08/11/2006	NY Southern District	11
37.	06-10977	In Re: Silicon Graphics, Inc., Morgan Stanley Senior Funding, Inc.	05/08/2006	NY Southern District	11
38.	06-11144	In Re: Storehouse, Inc., Garry W. Angle	09/18/2006	Eastern District of VA	11
39.	06-11142	In Re: The Rowe Companies, Garry W. Angle, <i>et al.</i>	09/18/2006	Eastern District of VA	11
40.	07-00762	In Re: Trans Continental Airlines Inc	03/01/2007	Middle District of FL	11
41.	08-10720	In Re: Tricom, S.A	02/29/2008	NY Southern District	11
42.	06-80899	In Re: TSG, Inc, TSG Rural, LLC, <i>et al.</i>	11/08/2006	Eastern District of OK	11
43.	06-12827	In Re: U.S. Energy Biogas Corp	11/29/2006	NY Southern District	11
44.	06-10725	In Re: USA Commercial Mortgage Company, USA Capital Realty Advisors, LLC, <i>et al.</i>	04/13/2006	Nevada	11
45.	08-10623	In Re: VI Acquisition Corp.	04/03/2008	Delaware	11
46.	08-10768	In Re: Ziff Davis Media Inc.	03/05/2008	NY Southern District	11