DISINTERESTEDNESS AND DISCLOSURE IN RETENTION OF PROFESSIONALS" SHOULD INVESTMENT BANKERS BE HELD TO THE SAME STANDARDS AS ATTORNEYS?

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American Bankruptcy Institute
4th Annual Investment Banking Program
New York, NY September 20, 2004

Although, historically, the professionals involved in a chapter 11 case consisted of primarily attorneys and accountants, today investment bankers, turnaround specialists and financial consultants are necessary players in a chapter 11 case. And not just in the mega-cases anymore. These types of professionals are regularly employed in small and mid-size cases as well. The provisions of the Bankruptcy Code governing retention of professionals[2], however, impose a relatively high standard, that of "disinterestedness," in order for a professional to be retained. These provisions were drafted based on the practices and rules of ethics that govern attorneys. Accountants, like attorneys, have professional guidelines to follow in their practice as well. But what about investment bankers? Clearly there is no "Investment Banker Code of Ethics," so in the bankruptcy context, should investment bankers be held to the same ethical standards as attorneys and accountants?

I. Section 327(a)

Section 327(a) of the Bankruptcy Code permits a trustee or debtor in possession to employ professionals. *See* 11 U.S.C. § 327(a). Section 327(a) imposes two requirements in order for an attorney or other professional person to be employed by a debtor. The attorney or professional person must first be a disinterested party, as defined in 11 U.S.C. § 101(14). The second requirement is that the attorney or professional person cannot hold or represent an interest that is adverse to the estate.

A. Disinterested Person

Section 101(14) of the Bankruptcy Code provides a broad definition of a "disinterested persons." Section 101(14) provides a list of persons who are not disinterested. Under 101(14), any professional will be disqualified from employment by the debtor if that professional (A) was a creditor, an equity security holder, or an insider of the debtor; (B) was an investment banker for any outstanding security of the debtor; (C) or an investment banker for a security issued within three years prior to the date of filing the petition; (D) was a director, officer or employee of the debtor or an investment banker within two years of the petition date; (E) or has an interest

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[2] *See* 11 U.S.C. § 327 and § 101(14) and Fed. R. Bankr. P. 2014.

materially adverse to the estate for any other reason. See 11 U.S.C. § 101(14)(A)-(E) emphasis added.

B. Materially Adverse Interest

Interestingly, unlike "disinterested person," the term "adverse interest" is not defined under the Code. Whether an adverse interest exists in any particular manner is determined on a case by case basis. *See In re Caldor, Inc.,* 193 B.R. 165, 171 (Bankr. S.D.N.Y. 1996). The Second Circuit has recognized that the definition of "adverse interest" often used by many courts in this regard is:

> (1) to possess or assert any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant, or (2) to possess a predisposition under circumstances that render such a bias against the estate.

In re Arochem Corp., 176 F.3d 610, 623 (2d Cir. 1999)(quoting *In re Roberts,* 46 B.R. 815 (Bankr. D. Utah 1985).

It is notable that the materially adverse interest standard incorporated into the definition of "disinterested person" under § 101(14)(E) and the "interest adverse to the estate" language in § 327(a) overlap and are duplicative. The Court in *In re Granite Partners, L.P.,* 219 B.R. 22, 23 (Bankr. S.D.N.Y. 1998) found there to be a single "disinterestedness" test by which to judge conflicts.

(i) Actual v. Potential Conflicts

Some courts distinguish between "actual" and "potential" conflicts. *BH & P Inc.,* 949 F.2d 1314 (3d Cir. 1991)(focus of inquiry is whether there is an actual conflict of interest); *In re McKinney Ranch Assocs.,* 62 B.R. 249, 255 (Bankr. C.D. Cal. 1986)(remote potential conflict should not result in disqualification). The Third Circuit distinguishes actual conflicts, potential conflicts, and appearances of conflict. *See In re Marvel Entm't Corp.*, 140 F.3d 463, 476 (3d Cir. 1998); *but see In re Zenith Electronics Corp.,* 241 B.R. 92 (D. Del. 1999)(financial advisor's prior representation of majority shareholder and largest creditor of debtor that occurred two years prior to the filing and lasted only 5 days "created an insurmountable barrier" to the retention); *see also In re Kendavis Indus. Int'l, Inc.,* 91 B.R. 742 (Bankr. N.D. Tex. 1988)(finding that the concept of potential conflicts is a contradiction, once there is a conflict, it is actual, not potential). For more on this topic, see Marcia Goldstein, Melissa I. Hoffman, Craig E. Johnson, Weil, Gotshal & Manges, LLP, Retention of Professionals in Bankruptcy Cases: Ethical Issues and Special Considerations, American Law Institute—American Bar Association Continuing Legal Education, June 10-12, 2004.

(ii) Large, Complex Cases Require Practical Approach

In large, complex cases, however, it is difficult for a debtor to retain counsel with no potential conflicts of interest. Many courts in more recent years take a more practical approach,

in line with the "actual" conflict camp. One of many examples is the *Enron* case. In *Enron*, the bankruptcy court heard motions to disqualify the counsel chosen by the unsecured creditors' committee, as well as by the former employee's committee. The court approved the use of co-counsel to handle conflict situations, and found that an internal screening process put in place by a law firm was an acceptable means of addressing potential conflicts. The court also found that the fact that the law firm was simultaneously involved in representing a surety in non-bankruptcy litigation involving Enron transactions was not a disabling conflict that would preclude representation of the committee. *See In re Enron Corp.,* (Bench Decision and Order dated May 23, 2002, Bankr. S.D.N.Y., Case No. 01-16034 (AJG)) *upheld by In re Enron Corp., v. Milbank, Tweed, Hadley & McCloy, LLP,* 2003 WL 223455 (S.D.N.Y.). For more on this topic, see Marcia Goldstein, Melissa I. Hoffman, Craig E. Johnson, Weil, Gotshal & Manges, LLP, Retention of Professionals in Bankruptcy Cases: Ethical Issues and Special Considerations, American Law Institute—American Bar Association Continuing Legal Education, June 10-12, 2004.

II. Rule 2014 Disclosure

Federal Rule of Bankruptcy Procedure 2014(a) provides that in order to be retained by a debtor in a bankruptcy case, a professional must provide an affidavit setting forth the professional's "connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States Trustee, or any person employed in the office of the United States Trustee." Fed. R. Bankr. P. 2014(a).

A. Full Disclosure Required

Rule 2014(a) requires full disclosure of all facts relating to the proposed employment of a professional. Courts have held that attorneys are required to disclose any and all connections and contacts with all parties and potential parties in a case, no matter how minor they might seem at the time. What facts and the extent to which they should be disclosed are not the attorney's decision to make, and attorneys may not unilaterally determine "the relevance of a connection" to a debtor. *See In re The Leslie Fay Companies, Inc.,* 175 B.R. 525, 536 (Bankr. S.D.N.Y. 1994); *see also In re Hot Tin Roof, Inc.,* 205 B.R. 1000, 1003 (1st Cir. BAP 1997). Nor can professionals determine that certain connections to the debtor are not important enough to disclose. *See In re Arlan's Dep't. Stores,* 615 F.2d 932 (2d Cir. 1979); *In re Envirodyne Indus.,* 150 B.R. 1008 (Bankr. N.D.Ill. 1993)(holding that no matter how trivial a connection appears to the professional seeking employment, it must be disclosed). Penalties for a failure to disclose tend to be more severe than those for what subsequently may turn out to be inadequate disclosure. Of course, intentional (as opposed to inadvertent) non-disclosure carries the most severe penalties, including full forfeiture of fees.

B. Ongoing Duty to Disclose

Professionals are also subject to a continuing duty to disclose conflicts. As every bankruptcy practitioner knows, new parties appear in cases all the time, and old parties, who were not adverse, become adverse through changes in circumstance and case dynamics. Any new issues or matters that arise in the course of the representation must be brought to the

attention of the court. Otherwise, the professional runs the risk that the court will find a violation of Rule 2014(a). In *In re Granite Partners,* 219 B.R. at 35, prior to its retention, the trustee's counsel disclosed the fact that counsel had a relationship with an adverse client consisting of five open but unrelated matters. The trustee subsequently increased its representation of the adverse client by opening over 400 new matters for the client, without supplementing its disclosure to the trustee or the court. The bankruptcy court held this to be a clear violation of Rule 2014(a).

Disclosure is an important element for a professional in the employ of a debtor. A failure to disclose, whether pre-retention or post-retention, constitutes an independent ground for denial of some or all compensation. *See In re Filene's Basement, Inc.,* 239 B.R. 845 (Bankr. D. Mass. 1999); *In re Tinley Plaza Assocs., L.P.,* 142 B.R. 272, 278 (Bankr. N.D. Ill. 1992). A knowing failure to disclose conflicts can subject a professional to criminal penalties under title 18 of the United States Code. Section 152 of title 18 provides for fines and imprisonment for knowingly making fraudulent statements in any case under title 11. 18 U.S.C. § 152(2).

III. Should Investment Bankers Be Held to the Same Standard As Attorneys?

The Bankruptcy Code strictly prohibits a debtor or committee from employing an investment banker who has served as an investment banker for any outstanding security of the debtor or a professional that has been, within three years before the petition date, an investment banker for a security of the debtor, regardless of whether that security is still outstanding. Whether these restrictions make sense is a matter of great debate. Investment bankers would assert that the mere participation as an underwriter of a debtors' securities have no bearing on the ability of an investment advisor to subsequently serve as a financial advisor to a committee or debtor. However, based on the recent spate of "mega fraud" bankruptcy cases, in which financial institutions and their affiliated investment banks have become major litigation targets, the drafters of the Code may seem more prescient than impractical.

A. Proposed/Pending Legislation

The efforts to relax the standard of disinterestedness have reached Congress several times. The most recent is H.R. 975, which has passed in the United States House of Representatives, and awaits consideration in the Senate, proposes to amend the definition of "disinterested person" contained in section 101(14) of the Bankruptcy Code to eliminate all references to investment bankers. This amendment would permit the retention of an investment banker, even if the applicant had recently been an investment banker for a security of the debtor. This revision to the Code is and has been stalled along with all other bankruptcy reform legislation over the last several years.

B. Practical Considerations

As stated previously, whether a standard that blocks from employment a professional most familiar with the debtor's securities makes sense is debatable. Courts, however, have strictly enforced the disinterestedness language of the Code, in some cases even when the court found it to result in an anomaly.

For example, in *In re Eagle Pitcher Industries,* 999 F.2d 969 (6th Cir. 1993), the bankruptcy court determined that although Goldman, Sachs was "technically" not disinterested under 101(14) because it had underwritten some of the debtor's securities prior to the filing, it did not have an actual conflict, and therefore, should be allowed to be retained as the debtor's financial advisor. The U.S. Trustee objected to the retention, and the matter was appealed to the Circuit Court, which reversed the bankruptcy court's decision. The Circuit Court held that "the language of section 327(a), when read in conjunction with the definitions set out in section 101(14) does not leave room for debate: Goldman, Sachs is and was an investment banker for outstanding securities of the debtors, and as such, is not a disinterested person within the meaning of the statute…" The Court went on to state that "[i]t is moreover, clear from both the statute and from *Middleton Arms* (another disinterestedness case in the court) that a person cannot be "disinterested," yet without any adverse interest. Although it may make little sense to the bankruptcy court and the debtors—or, for that matter to this court—that Goldman, Sachs is not permitted to serve as financial advisor, the statute requires that result."

Under this statutory scheme, chapter 11 debtors are prevented from retaining an investment bank as a result of services the investment bank previously rendered to the debtor company prior to the bankruptcy. An investment bank will be disqualified from acting as a professional in a debtor's chapter 11 case if at any time prior to the bankruptcy it played a role, whether large or small, in connection with prepetition issuance of securities of the debtor. This occurs even if the investment bank does not have a materially adverse interest to the debtor or any of its constituents, as is often the case. Some practitioners and scholars argue that the "disinterestedness" standard as it applies to investment bankers results in negative public policy implications by precluding a debtor from utilizing the services of the investment bank with the greatest familiarity with its business and the circumstances that led to its financial difficulties. For companies which have accessed the public equity markets, the statutory language as it stands arguably precludes the debtor from engaging the services of every major full service investment bank, because all may have been underwriters, at one point, of the debtor's securities.

Recently, in the *Adelphia* case, the "disinterestedness" standard arose to eliminate several investment banks from contending for employment as financial advisors to the company for the purposes of finding potential buyers, after the strategy of solely reorganizing the company through a standalone plan were reevaluated. Lazard had been retained at the beginning of the case to assist with the development of a stand alone plan. Such a plan was developed and filed with the court, but met with little support from any major creditor constituency. Therefore, even though Lazard's retention letter contemplated a possible sale of all or parts of the company, creditors were concerned that Lazard's championing of the standalone plan itself created a potential conflict for Lazard in advising Adelphia on the sale of all or part of the company. Thus, Adelphia was forced to seek to employ additional investment advisors, even though multitudes of Adelphia debt and equity securities had been issued by Adelphia and its affiliated entities. Although in the end, Adelphia was able to retain UBS Securities LLC and Allen & Co. to act as merger and acquisitions financial advisors, significant numbers of the major players were conflicted out due to the strict statutory scheme of the Bankruptcy Code. See Dennis Fitzgerald, Deal Diary, <u>The Deal</u>, May 24, 2004. Also out would have been Citigroup Global Markets Inc. and J.P. Morgan Securities Inc., based upon their standing as agents in Adelphia's pre-petition bank facility. *Id.*

C. Fiduciary duty to estate

But perhaps this push to remove the higher standard imposed by the present Code from investment bankers is missing something. The professional codes and rules of ethics for attorneys and accountants are based on the fiduciary nature of their professions. There is no question that attorneys, accountants, directors and officers are fiduciaries of the corporations they serve. The Code is also clear that statutory creditors committees serve as fiduciaries to their constituents and that the members of a committee serve in a fiduciary capacity.

In their general practice, most would not hold financial advisors to be fiduciaries. However, some courts have suggested that in the bankruptcy context financial advisors may owe a higher level of care than in ordinary practice. *Compare e.g., In re Gillett Holdings*, 137 B.R. 452, 458 (Bankr. D. Colo. 1991) ("Investment bankers and financial advisors hired by the Debtor are also fiduciaries."), and *In re Allegheny Int'l, Inc.*, 100 B.R. 244, 246 (Bankr. W.D. Pa. 1989) ("We now hold that the investment bankers/financial advisors hired by the debtor and the Creditors' Committee are also fiduciaries."), *with In re Joan and David Halpern Inc.*, 248 B.R. at 46 (earlier cases rejecting indemnification "overlook the common law principles permitting indemnity of fiduciaries, and the idea that a fiduciary cannot be indemnified for negligence, or that such indemnification is contrary to public policy, is just plain wrong"), *In re Mortgage & Realty Trust*, 123 B.R. 626, 631 (Bankr. C.D. Cal. 1991) (rejecting indemnification because it is inconsistent with "professionalism," but not holding financial advisors to be fiduciaries), and *In re Drexel Burnham Lambert Group*, 133 B.R. 13, 27 (Bankr. S.D.N.Y. 1991) (same). If a company in bankruptcy or its creditors requires a higher level of care by all of its employed professionals than a company that is not seeking the protections of the Code, then the removal of the standards for investment bankers from the Code could be detrimental to the debtor and creditors, as well as to the system itself.

IV. Conclusion

As investment and financial advisors become more prevalent in cases and as the disinterestedness test is applied more strictly by US Trustees and the courts, it is probably just a matter of time before investment advisors are held to the higher standards of attorneys and accountants. In the post-Enron climate of Sarbanes Oxley, one supposes that Congress will be disinclined to loosen the standards for those who underwrote many of the securities which are either themselves being challenged as being fraudulent or which caused millions of public investors to lose significant money.

Additionally, other types of conflicts of interest have begun to surface in the investment advisor context, which appear to be more in the vein of the “appearance of impropriety” standard applied to lawyers, rather than the simple statutory definition of disinterestedness. For example, as seen in *Adelphia*, creditors believed that a common change in restructuring strategy, from a stand alone plan to a possible sale, necessitated an entirely new set of investment advisors. In a perfect world, an investment advisor who is retained to restructure the company and is compensated, as is customary, for obtaining the highest possible value, whether through a sale or internal restructuring, should not run afoul of any creditor’s goal of maximizing value. Yet

creditors believed that the combination of the initial advisor's development of a stand alone plan, with the debtors' ambivalence about a sale of the company, created a conflict, necessitating the retention of investment advisors whose sole goal and compensation was sale-based.

In another case involving a sale issue, after a marketing process, the investment advisor brought in a potential buyer and sought the consent of the committee for that potential buyer to serve as the stalking horse. The committee had its own potential buyer in the wings. Tension was created by the committee's support of its own potential buyer, who clearly, for stalking horse purposes, had submitted the highest and best offer, when the financial advisor felt loyalty to the bidder it had brought to the table.

These and many other scenarios can cause conflicts for investment advisors far beyond the statutory issues of disclosure and disinterestedness. These issues are exacerbated by the investment banker compensation system which is based on "value added" rather than the traditional hourly rates of attorneys and accountants. As bankruptcy cases become larger and more litigious, the conflicts issues surrounding investment advisors, their retention and their compensation will become more pronounced, and investment advisors may well find themselves subject to some of the more traditional conflicts and ethical standards of their co-professionals.