

***American Bankruptcy Institute
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Ethics committee Session:***

***It's a Small, Small, Small World
Inherent Conflicts in Representation of Closely Held
Entities and Joint Representation***

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Disclosure Requirements Under FED. R. BANKR. P. 2019

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I. Introduction

Rule 2019¹ generally governs the disclosures that must be made by “every entity or committee representing more than one creditor or equity security holder and, unless otherwise directed by the court, every indenture trustee” in chapter 9 municipality or chapter 11 reorganization cases. Committees appointed pursuant to sections 1102 and 1114 of the Code² are expressly excepted from the disclosure requirements imposed by Rule 2019.³

The disclosures required by Rule 2019 must be made in the form of a “verified statement” filed with the court.⁴ In its current form, Rule 2019 spells out the “data required” for inclusion in the verified statement,⁵ as well as the consequences for failure to make the requisite disclosures.⁶ The Rule 2019 disclosure requirements have the potential to impact a variety of participants in the bankruptcy process, including without

¹Unless otherwise noted, the terms “Rule” and “Rules” in this article refer to the Federal Rules of Bankruptcy Procedure, FED. R. BANKR. P. 1001 *et seq.*

²Unless otherwise noted, the term “Code” in this article refers to the United States Bankruptcy Code, 11 U.S.C. § 101 *et seq.*

³*See* FED. R. BANKR. P. 2019(a).

⁴*Id.*

⁵*Id.*

⁶*See* FED. R. BANKR. P. 2019(b).

limitation *ad hoc* committees, hedge funds, distressed debt investors, agents under a variety of credit agreements, loan participants, and indenture trustees.

Bankruptcy courts have had to wrestle with the issue of whether a particular “entity or committee” must comply with Rule 2019 recently, and with increasing frequency. Significant amendments to Rule 2019 have recently been proposed in order to clarify and give added substance to the disclosure mandated by the rule. Those amendments are currently subject to public comment. If approved, Rule 2109 in its amended form will have a significant impact on the disclosures that must be made by the entities, groups and committees that fall within its scope.

II. **Rule 2019: A Historical Perspective**

The roots of Rule 2019 predate the current Bankruptcy Code. In the 1930's, concerns had developed as to whether unofficial committees formed in equity receiverships and other forms of corporate reorganization were engaged in abusive practices that impacted negatively on the development of fair and equitable plans of reorganization. Those concerns triggered a study and report spearheaded by then-Professor William O. Douglas⁷ for the Securities and Exchange Commission.⁸ The results of that study and report “led directly to the adoption of Chapter X⁹ and Rule 10-211 thereunder, which provided for disclosure of the ‘personnel and activities of those acting in a representative capacity’ in order to help foster fair and equitable plans free from deception and overreaching.”¹⁰

⁷William O. Douglas was subsequently confirmed as a Justice of the United States Supreme Court on April 4, 1939.

⁸The result of the study was a four-volume writing titled Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1937). See In re Northwest Airlines Corp., 363 B.R. 701, 704 (Bankr. S.D.N.Y. 2007).

⁹Reference is to Chapter X of the Bankruptcy Act of 1898 (“Act”).

¹⁰Northwest Airlines, 363 B.R. at 704, citing 13A King *et al.*, Collier on Bankruptcy ¶ 10-211.04 (14th ed. 1976).

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Rule 10-211 under the Act was largely unaffected by the enactment of the Code in 1978. The drafters of the Code and related Rules chose to “retain[] the substance of former Rule 10-211 in Bankruptcy Rule 2019 as ‘a comprehensive regulation of representation in chapter 9 and chapter 11 reorganization cases.’”¹¹

III. Disclosure Requirements Under Current Rule 2019

In its current form, Rule 2019 requires two distinct disclosures. First, the party making the disclosure must divulge certain information as to the identity of, and claims held by, the creditors or equity security holders to be represented in the case. Second, the party making the disclosure must provide documentation confirming that the creditors or equity security holders to be represented in the case have, in fact, authorized the representation.

A. Disclosure of the Creditors or Equity Holders to be Represented

The verified statement filed by a party seeking to comply with Rule 2019 must contain the following information:

- »The name and address of the creditor(s) or equity security holder(s) who will be represented¹²;
- »The nature and amount of each claim or interest represented, and the time of acquisition the claim or interest, unless it is alleged to have been acquired more than one year prior to the filing of the petition¹³;

¹¹Northwest Airlines, 363 B.R. at 704, *citing* Advisory Committee Note to Bankruptcy Rule 2019 *and* Report of the Commission on Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93rd Cong., 1st Sess. 242-43 (1973).

¹²FED. R. BANKR. P. 2019(a)(1).

¹³FED. R. BANKR. P. 2019(a)(2).

»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 act¹⁴; and

»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 amount of claims or interests owned by the entity, the members of the committee or the indenture trustee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.¹⁵

To summarize, “[b]y its plain terms, the Rule 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.’”¹⁶

B. Disclosure of Documents Authorizing Representation

The verified statement must also “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 [.]”¹⁷

IV. Consequences of Failure to Make Disclosures Required by Rule 2019

¹⁴FED. R. BANKR. P. 2019(a)(3).

¹⁵FED. R. BANKR. P. 2019(a)(1).

¹⁶Northwest Airlines, 363 B.R. at 702.

¹⁷FED. R. BANKR. P. 2019(a)(1).

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Rule 2019(b) spells out the consequences in the event that an entity subject to the rule fails to make the requisite disclosures. In such circumstances, “[o]n motion of any party in interest or on its own initiative, the court may:

»Refuse to permit the entity making the disclosure “to be heard further or to intervene in the case”¹⁸;

»Review, and if warranted “grant appropriate relief” from 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 Code¹⁹; and

»Deem any “authority, acceptance, rejection, or objection given, procured, or received by an entity or committee who has not complied with this rule” to be invalid.²⁰

V. **The Battleground: Rule 2019 Disclosure Requirements vs. Confidentiality Concerns**

In several recent cases, bankruptcy courts were faced with various arguments seeking to avoid or limit compliance with the disclosures mandated by Rule 2019.²¹ The

¹⁸FED. R. BANKR. P. 2019(b)(1).

¹⁹FED. R. BANKR. P. 2019(b)(2).

²⁰FED. R. BANKR. P. 2019(b)(3).

²¹*See, e.g., In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007); *In re Northwest Airlines Corp.*, 363 B.R. 704 (Bankr. S.D.N.Y. 2007); *Baron & Budd, P.C. v. Unsecured Asbestos Claimants Comm.*, 321 B.R. 147 (D.N.J. 2005); *In re Pittsburgh Corning Corp.*, 2005 WL 6128987 (W.D. Pa. Sept. 27, 2005)(unpublished disposition), *aff’d*, *In re Pittsburgh Corning Corp.*, 260 Fed. Appx. 463 (3d Cir. 2008)(unpublished disposition); *In re Scotia Development, LLC*, No. 07-20027 (Bankr. S.D. Tex. 2007).

cornerstone of those arguments was that the rule unnecessarily required disclosure of confidential and proprietary commercial information by stakeholders in bankruptcy reorganization cases. The parties advancing the arguments contended that:

- (1) The entity from whom disclosure was sought was not a “committee,” and was therefore not subject to the disclosure requirements of Rule 2019²²; and/or
- (2) Even if the entity from whom disclosure was sought was in fact a “committee” in the context of Rule 2019, it was necessary to file the verified statement containing the requisite disclosures under seal pursuant to 11 U.S.C. § 107(b) in order to protect the disclosing party’s “confidential commercial information.”²³

Courts having addressed those issues reached differing conclusions as to the extent of the disclosure required by Rule 2019.²⁴ At present, and perhaps as a result, Rule 2019 is

²²See Scotia Development, *supra* at note 21 (Court concluded that because as hoc group of noteholders did not seek or purport to represent anyone other than the members of the group themselves, the noteholder group was not a “committee” in the context of Rule 2019, and therefore did not have to make disclosures in compliance with that rule); *see, e.g.,* Northwest Airlines, 363 B.R. 701, 703 (Bankr. S.D.N.Y. 2007)(in concluding that an *ad hoc* committee of equity security holders had to make disclosures required by Rule 2019, Court noted that “[t]here may be cases where a law firm represents several individual clients and is the only entity required to file a Rule 2019 statement, on its own behalf.”), *citing* In re CF Holding Corp., 145 B.R. 124 (Bankr. D. Conn. 1992).

²³*See, e.g.,* In re Northwest Airlines Corp., 363 B.R. 704, 706-07 (Bankr. S.D.N.Y. 2007) (after balancing the policies advanced by Rule 2019 with the policies underpinning 11 U.S.C. § 107(b), court declined to seal Rule 2019 disclosures made by *ad hoc* committee of equity security holders); *see also* In re Pittsburgh Corning Corp., *supra* at note 21 (court required complete Rule 2019 disclosures, but limited service of the disclosure papers to the chapter 11 debtor, the United States Trustee, and allowed disclosure to other parties only after the filing of a motion and entry of an order by the court).

²⁴*Compare* Northwest Airlines, 363 B.R. 701, 703 (Bankr. S.D.N.Y. 2007)(concluding that an *ad hoc* committee of equity security holders had to make disclosures required by Rule 2019) *with* In re Pittsburgh Corning Corp., *supra* at note 21 (court required complete Rule 2019 disclosures, but limited service of the disclosure papers to the chapter 11 debtor, the United States Trustee, and allowed disclosure to other parties only after the filing of a motion and entry of an order by the court) *and* Scotia Development, *supra* at note 22 (concluding that because *ad hoc* group of noteholders did not seek or purport to represent anyone other than themselves, they were

under scrutiny. As is discussed below, substantive amendments are pending that may eliminate some of the existing disputes regarding the proper scope of disclosure under Rule 2019. The amendments may also resolve the question of whether those disclosure requirements can be “blithely avoided” by simply characterizing a group of creditors or equity security holders acting in concert as something other than a “committee.”²⁵

VI. Proposed Amendments to Rule 2019

In August of 2009, proposed amendments to the text of Rule 2019 were published for public comment. The proposed amendments will be distributed at this session.²⁶ If the present version of the amended rule remains intact when the rulemaking process runs its course, Rule 2019 will be titled “Disclosure Regarding Creditors and Equity Security Holders in Chapter 9 and Chapter 11 Cases.” The Committee Notes drafted in connection with the proposed amendments to Rule 2019 contain a cogent summary of the impact of the suggested amendments:

The rule is substantially amended to expand the scope of its coverage and the content of its disclosure requirements. Stylistic and organizational changes are also made in order to provide greater clarity. Because the rule no longer applies only to representatives of creditors and equity security holders, the title of the rule has been changed to reflect its broadened focus on disclosure of financial

not a “committee” in the context of Rule 2019, and therefore did not have to make disclosures in compliance with that rule.)

²⁵See Northwest Airlines, 363 B.R. 701, 703 (Bankr. S.D.N.Y. 2007).

²⁶The proposed amendments to Rule 2019, as well as proposed amendments to a number of other federal rules, can also be found on the internet at: <http://www.uscourts.gov/rules/newrules1.htm>. The period for public comment on the proposed amendments to Rule 2019 will expire on February 16, 2010.

information in chapter 9 and chapter 11 cases.

More particularly, if the pending amendments are ultimately approved through the rulemaking process, revised Rule 2019 will:

»Include the new term “disclosable economic interest.” That term is defined to encompass “any claim, interest, pledge, lien, option, participation, derivative instrument, or any other right that grants the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest.” The Committee Notes indicate that the definition “is intended to be sufficiently broad to cover any economic interest that could affect the legal and strategic positions a stakeholder takes in a chapter 9 or chapter 11 case. *A disclosable economic interest extends beyond claims and interests owned by a stakeholder.*”²⁷

»Expand the disclosure requirements to “every entity, *group*, or committee *that consists of or represents* more than one creditor or equity security holder[.]”²⁸

»Expand the disclosure requirements by allowing the court, *sua sponte* or on the motion of a party in interest, to require certain disclosures from “an entity that seeks or opposes the granting of relief.”²⁹

»Preserve the exception from Rule 2019 reporting requirements for committees appointed pursuant to sections 1102 and 1114 of the Code;³⁰

²⁷Proposed FED. R. BANKR. P. 2019(a)(emphasis added) and related Committee Notes.

²⁸Proposed FED. R. BANKR. P. 2019(b)(emphasis added) and related Committee Notes. If ultimately approved, this provision would do much to eliminate the semantic debate as to whether several creditors or equity security holders acting in concert are a “committee” subject to Rule 2019 disclosure requirements, or a “group” that is not. *See* note 24, *supra*.

²⁹Proposed FED. R. BANKR. P. 2019(b) and (c)(2).

³⁰*See* Proposed FED. R. BANKR. P. 2019(c)(1) and (3).

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»Preserve the requirement that “a copy of the instrument, if any, authorizing the entity, group, committee, or indenture trustee to act on behalf of creditors or equity security holders” be included with the verified statement filed in compliance with Rule 2019.³¹

»Require the filing of a supplemental statement “monthly, or as the court otherwise orders” if there are material changes in the facts set forth in a verified statement previously filed in compliance with Rule 2019.³²

»Expand the court’s authority under Rule 2019, allowing the court to impose sanctions, including “other appropriate relief,” in cases where there was a failure to “comply with the provisions of [the] rule;” a failure to comply “with any other applicable law regulating the activities and personnel of any entity, group, committee, or indenture trustee;” or “any impropriety in connection with any solicitation.”³³

VII. What Does the Future Hold for Parties Facing Rule 2019 Disclosure Requirements?

There is little question that practitioners who represent an “entity or committee representing more than one creditor or equity security holder” face difficult choices in advancing the interests of their clients under the current state of the law. The following are just a few examples of those dilemmas:

»Given the fact that I represent multiple creditors in the same bankruptcy case, is

³¹Proposed FED. R. BANKR. P. 2019(c)(4).

³²Proposed FED. R. BANKR. P. 2019(d).

³³Proposed FED. R. BANKR. P. 2019(e).

it possible to discharge the professional duties that I owe to each of my clients?

»Given the fact that I represent multiple creditors in the same bankruptcy case who routinely share information amongst themselves and with me, have I taken appropriate steps to preserve the attorney-client privilege for each of my clients?

»In order to protect my client's "confidential commercial information," do I have a duty to my client (and a good faith basis in fact and law) to argue that my client is not a "committee" and decline to make Rule 2019 disclosures?

»If a party moves to compel compliance with Rule 2019, and my client has been found to be a "committee" subject to that rule, do I have a duty to my client (and a good faith basis in fact and law) to request permission to file the resultant verified statement under seal?

It is too early to know whether the pending amendments to Rule 2019 will survive the rulemaking process. If the amendments to Rule 2019 in their present form remain intact after running the rulemaking gauntlet, the modified rule would certainly appear to resolve some of the sticky disclosure issues currently facing courts and parties in interest in the reorganization process. The revised rule would also significantly expand the disclosure requirements borne by "every entity, group, or committee that consists of or represents more than one creditor or equity security holder and, unless the court directs otherwise, every indenture trustee" in chapter 9 and chapter 11 bankruptcy proceedings on a going forward basis. Only time will tell if the proposed modifications to Rule 2019 will strike an effective balance between the desire of stakeholders in bankruptcy cases to preserve and protect confidential and proprietary commercial information on the one hand, and the need for substantive disclosure to ensure that "fair and equitable plans free

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from deception and overreaching”³⁴ are the net result of the bankruptcy reorganization process on the other.

³⁴*See* note 10, *supra*.

The Use and Effectiveness of Prospective Conflict Waivers

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Conflict – Defined

A logical starting point in considering the use and effectiveness of prospective conflict waivers begins with understanding what constitutes a conflict. The answer to this question can only truly be answered on a case by case basis by applying specific facts to applicable ethical rules, ethical opinions and case law. For purposes of this review, we will refer to the ABA Model Rules (the “Model Rules”) and the related ABA Model Rule Opinions (the “Model Rule Opinions”). Model Rule 1.7(a), set forth below, establishes when a concurrent conflict exists.

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

In circumstances where a concurrent conflict exists pursuant to Model Rule 1.7(a), Model Rule 1.7(b) sets forth conditions, each of which must be satisfied, for an attorney to be permitted to represent a potential client notwithstanding a concurrent conflict of interest. Section 1.7(b) provides:

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

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(4) each affected client gives informed consent, confirmed in writing.

In the context of a bankruptcy proceeding and the retention of professionals pursuant to bankruptcy code 327(a), the Model Rules overlap with the conflict rules of the bankruptcy code. In a bankruptcy matter, a conflict exists if such professional holds or represents an interest adverse to the estate, and is not a disinterested person. *See* 11 U.S.C. 327(a) and 327(c). The meaning of “to hold or represent an interest adverse to the estate” has been interpreted to mean: (1) to hold or assert any economic interest that would tend to reduce the value of the bankruptcy estate or that would give rise to an actual or potential dispute in which the estate is a rival claimant; or (2) to possess a predisposition under circumstances that render such predisposition a bias against the estate. *Matter of CF Holding Corp.*, 164 B.R. 799 (Bankr. D. Conn. 1994). The term “disinterested person” is defined in section 101(14) of the Bankruptcy Code as

“a person that (A) is not a creditor, equity security holder, or an insider; (b) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and (C) 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.”

Unlike a commercial setting in which satisfying the exception conditions under Model Rule 1.7(b) will allow an attorney to proceed with the concurrent representation in an ethically acceptable manner, a bankruptcy proceeding imposes a greater scrutiny of conflicts. For instance, an actual conflict of interest for an attorney retained under the Bankruptcy Code imposes a per se disqualification. *See In re Marvel Entertainment Group, Inc.* 140 F.3d 463, 476 (3d Cir. 1998). Furthermore, a bankruptcy court may not find that a waiver, which would otherwise cure a conflict in a commercial setting, cures a lack of disinterestedness or an adverse interest to the estate in a bankruptcy proceeding. *See e.g. In Re Granite Partners, L.P.*, 219 B.R. 22 (Bankr. S.D.N.Y. 1998); *In re Perry*, 194 B.R. at 880; *In re Envirodyne Indus., Inc.*, 150 B.R. 1008, 1016 (Bankr.N.D.Ill.1993); *In re Tinley Plaza Assocs.*, 142 B.R. at 278; *In re Diamond Mortgage Corp.*, 135 B.R. 78, 90 (Bankr.N.D.Ill.1990); *In re Amdura Corp.*, 121 B.R. 862, 866 (Bankr.D.Colo.1990); *see generally* 3 Lawrence P. King, *et al. Collier on Bankruptcy* ¶ 328.05[3], at 328-32; Robin E. Phelan & John D. Penn, *Bankruptcy Ethics, An Oxymoron*, 5 *Am. Bankr.Inst. L.Rev.* 1, 27 (1997) (“What may be ethically acceptable in commercial settings (*e.g.*, waivers upon informed consent) will not necessarily pass muster under section 327.”). *But cf. In re Lee*, 94 B.R. 172, 179 (Bankr.C.D.Cal.1988) (under Rule 5-102 of the California Rules of Professional Conduct, attorney desiring to represent both a debtor in possession and a conflicting interest must obtain a written waiver from the debtor, all creditors and the United States trustee).

The Prospective Waiver

A typical “general” or “open-ended” prospective waiver provides as follows:

The Company agrees that, notwithstanding our representation of the Company in this matter, we may, now or in the future, without seeking or obtaining your further consent, represent other persons whether or not they are now clients of our firm, in other matters, including litigation, where those other persons are adverse to the Company. The Company also agrees to not seek disqualification of our law firm should the firm sue the Company in the future.

In certain instances, more detail and specificity is provided by identifying specific adverse parties that the firm may in the future represent, or by identifying specific practice areas in which the firm may find itself adverse to the Company.

The central issue in determining whether a waiver is effective is consistently whether there was informed consent. In a situation in which there is a current conflict, informed consent requires that the attorney provide the client with the specific details of the current conflict such that the client: (i) is aware of the relevant circumstances, (ii) is aware of the material and reasonably foreseeable ways the conflict could adversely affect the client’s interests, and (iii) agrees to the proposed representation following the lawyer’s communication satisfying (i) and (ii) above. *See* Comment 18 to ABA Model Rule 1.7, provided in its entirety below.

[18] Informed consent requires that each affected client be aware of the relevant circumstances and of the material and reasonably foreseeable ways that the conflict could have adverse effects on the interests of that client. *See* Rule 1.0(e) (informed consent). The information required depends on the nature of the conflict and the nature of the risks involved. When representation of multiple clients in a single matter is undertaken, the information must include the implications of the common representation, including possible effects on loyalty, confidentiality and the attorney-client privilege and the advantages and risks involved. *See* Comments [30] and [31] (effect of common representation on confidentiality).

ABA Model Rule 1.0(e) defines informed consent as “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 conduct.” *See also* comments 6 and 7 to Model Rule 1.0 immediately following this review.

For an effective waiver of a current conflict, the lawyer’s communication to the client will require sufficient detail concerning the proposed representation and conflict in order to satisfy the informed consent requirement. In the case of an effective prospective

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waiver, however, the lawyer's communication necessary to satisfy the informed consent condition of Model Rule 1.7 may be permitted to be less detailed, depending upon certain other factors. Comment 22 to Model Rule 1.7 identifies the other factors to be considered in evaluating whether a prospective waiver is effective and include: (i) the extent to which the client reasonably understands the material risks; (ii) the level of the lawyer's comprehensive explanation pertaining to the types of future representations that might arise and the actual and reasonably foreseeable adverse consequences of those representations; (iii) whether the client is an experienced user of the legal services involved and is reasonably informed regarding the risk that a conflict may arise; and (iv) whether the client is independently represented by other counsel in giving consent and the consent is limited to future conflicts unrelated to the subject of the representation. Comment 22 to Model Rule 1.7 is provided in its entirety below.

[22] Whether a lawyer may properly request a client to waive conflicts that might arise in the future is subject to the test of paragraph [1.7](b). The effectiveness of such waivers is generally determined by the extent to which the client reasonably understands the material risks that the waiver entails. The more comprehensive the explanation of the types of future representations that might arise and the actual and reasonably foreseeable adverse consequences of those representations, the greater the likelihood that the client will have the requisite understanding. Thus, if the client agrees to consent to a particular type of conflict with which the client is already familiar, then the consent ordinarily will be effective with regard to that type of conflict. If the consent is general and open-ended, then the consent ordinarily will be ineffective, because it is not reasonably likely that the client will have understood the material risks involved. On the other hand, if the client is an experienced user of the legal services involved and is reasonably informed regarding the risk that a conflict may arise, such consent is more likely to be effective, particularly if, e.g., the client is independently represented by other counsel in giving consent and the consent is limited to future conflicts unrelated to the subject of the representation. In any case, advance consent cannot be effective if the circumstances that materialize in the future are such as would make the conflict nonconsentable under paragraph (b).

On May 11, 2005, Model Rule Opinion 05-436 pertaining to prospective waivers was issued. It is the first opinion issued since the Model Rules added Comment 22 specifically addressing prospective waivers. A copy of the complete opinion is set forth immediately following the conclusion of this review. Of particular interest is the language in the opinion which, referring to Comment 22, provides that

“The Comment goes further, however, by supporting the likely validity of an "open-ended" informed consent if the client is an experienced user of legal services, particularly if, for example, the client has had the opportunity to be represented by independent counsel in relation to such

consent and the consent is limited to matters not substantially related to the subject of the prior representation.”

It follows, therefore, that for those jurisdictions that have not adopted the amended Model Rules that include Comment 22 to Model Rule 1.7, it could be more difficult to obtain a finding of informed consent for a general or open ended prospective waiver (see e.g. *McKesson v. Duane Morris* below).

Case Law

As set forth above, an analysis of the conflicts and the use and effectiveness of prospective waivers is a fact intensive analysis not subject to a bright line rule. Therefore, to provide a perspective on the types of facts and issues that may affect the outcome of the effectiveness of a prospective waiver, below is a brief summary of certain instructional cases.

Century Indemnity Company et al v. Congoleum Corp. (In re Congoleum Corp.), 426 F.3d 675 (3d Cir. 2005). Gilbert Heintz (“GH”) sought retention under 327(e) as special counsel to Debtor while concurrently representing certain personal injury claimants as co-counsel in negotiating settlement arrangements against the insured. GH obtained waivers from both Congoleum and clients the firm represented with its co-counsel. However, GH relied on its co-counsel to secure the waivers. Co-counsel to GH executed engagement letters of GH on behalf of personal injury claimants waiving “all present and future conflicts of interest.” However, the Court did not find support to conclude that GH’s co-counsel was authorized by the clients to issue waivers on their behalf, nor did the record support a finding that co-counsel furnished the waivers to the personal injury claimants and provided them with an opportunity to object. For these reasons, the Court concluded that there was no informed consent.

Celgene Corp. v. KV Pharmaceutical Co., 2008 WL 2937415 (D.N.J. July 29, 2008). Buchanan Ingersoll & Rooney (Buchanan) represented both Celgene Corp. and KV Pharmaceutical. Celgene, speaking through in-house patent counsel, agreed to a prospective waiver provision in a 2003 and a 2006 engagement letter. In October 2007, Buchanan entered an appearance for KV as defendant in the patent infringement action commenced by Celgene. The Court concluded that Celgene did not provide informed consent. Under the applicable New Jersey Rules of Profession Conduct, conflict rule 1.7(b) called for “informed consent, confirmed in writing, after full disclosure and consultation...” Furthermore, the New Jersey RPC adopted the Model Rule definition of “informed consent.” The Court concluded that the prospective waiver language did not include any of the following elements of an informed consent: (i) adequate communication of proposed course of conduct, (2) explanation of material risks, or (3) explanation of reasonable available alternative to the proposed course of conduct.

McKesson Information Solutions v. Duane Morris (2006 CV 12110) (Fulton. Super. GA 2006). Duane Morris entered into an engagement to represent two related entities, McKesson Medication Management Inc. (MMI) and McKesson Automation Inc. (MAI)

in connection with a bankruptcy matter. The engagement letter contained a general prospective waiver which also specifically set forth that Duane Morris was only representing the two entities and not representing any affiliates or subsidiaries of MMI or MAI. Following this engagement, Duane Morris agreed to represent a party adverse to McKesson Information Solutions, LLC. (MIS) in an arbitration proceeding. MIS filed suit to disqualify Duane Morris due to a conflict of interest. MIS, MAI and MMM all share the same parent corporation. The Court rejected Duane Morris' attempt to explain away the conflict based on the fact that the entities are all separate legal entities. Citing to *Ramada Franchise Systems, Inc. v. Hotel of Gainesville Associates, et al.*, 988 F.Supp. 1460 (N.D. Ga. 1997), the Court conducted an economic relationship analysis of the related entities by reviewing whether the parent controlled the legal affairs of the subsidiary, whether the subsidiaries have similar management, share headquarters, share corporate principles and business philosophy, have the same legal department and whether the same officers have the same titles in the different subsidiaries. Finding that MIS, MAI and MMM have shared economic interests, the Court concluded that while the MIS, MAI and MMM entities are separate and legal entities for contract and liability purposes, they are a single entity for purposes of conflict analysis. A copy of the opinion of the Court is provided immediately following this review.³⁵

Visa U.S.A., Inc. v. First Data Corp., 241 F.Supp. 2d 1100 (N.D. Cal. 2003).

Law firm Heller Ehrman agreed to represent First Data in a patent infringement action subject to First Data agreeing to a prospective waiver that permitted the firm to represent Visa in future disputes arising between First Data and Visa. The Court found that First Data provided a fully informed advanced waiver. The factors the Court considered in determining whether First Data was fully informed were: the breadth of the waiver, its temporal scope, the quality of the discussion with the client, the specificity of the waiver, the nature of the actual conflict, the sophistication of the client and the interests of justice. The pertinent waiver language provided as follows:

Our engagement by you is also understood as entailing your consent to our representation of our other present or future clients in "transactions," including litigation in which we have not been engaged to represent you and in which you have other counsel, and in which one of our other clients would be adverse to you in matters unrelated to those that we are handling for you. In this regard, we discussed [Heller's] past and on-going representation of Visa U.S.A. and Visa International (the latter mainly with respect to trademarks) (collectively, "Visa") in matters which are not currently adverse to First Data. Moreover, as we discussed, we are not aware of any current adversity between Visa and First Data. Given the nature of our relationship with Visa, however, we discussed the need for the firm to preserve its ability to represent

³⁵ Following the Court's order disqualifying Duane Morris, Duane Morris withdrew from its bankruptcy representation. Because following Duane Morris' withdrawal there was no longer a concurrent conflict nor a conflict under Rule 1.9, the Court vacated as moot its injunction of disqualification.

Visa on matters which may arise in the future including matters adverse to First Data, provided that we would only undertake such representation of Visa under circumstances in which we do not possess confidential information of yours relating to the transaction, and we would staff such a project with one or more attorneys who are not engaged in your representation. In such circumstances, the attorneys in the two matters would be subject to an ethical wall, screening them from communicating from [sic] each other regarding their respective engagements. We understand that you do consent to our representation of Visa and our other clients under those circumstances.

Centennial Insurance Co. v. Apple Builders & Renovators, Inc., 60 A.D.3d 506 (N.Y.S. 2009). Defendant construction company attempted to disqualify plaintiff insurance company's attorneys since they were represented by the same law firm. Defendant claimed that it did not understand the implications of a waiver it signed, which allowed for possible conflicts of interest that might arise from the firm's representation of both plaintiff and defendant here. The Court denied Defendant's motion to disqualify the law firm because defendant had executed a written waiver in its retainer agreement with the same law firm specifically waiving any conflict of interest that might arise from the firm's representation of both plaintiff and defendant. The defendant was not allowed to compel disqualification of plaintiff's counsel solely because the representation to which it consented has escalated into litigation.

Additional Cases

For a comparison of additional opinions both favorable and not favorable to prospective waivers, See Freivogel on Conflicts, A Guide to Conflicts of Interests for Lawyers. *Courts Favorable. In re Agouron Pharmaceuticals, Inc.*, 194 F.3d 1329 (Fed. Cir. 1999) (district court had denied a motion to disqualify, citing, in part, an advance waiver; here appellate court denied mandamus on procedural grounds); *Unified Sewerage Agency of Washington County v. Jelco Corp.*, 646 F.2d 1339 (9th Cir. 1981); *City of Cleveland v. Cleveland Elec. Illuminating Co.*, 440 F. Supp. 193 (N.D. Ohio 1976, aff'd mem., 573 F.2d 1310 (6th Cir. 1977)); *Wolk v. Flight Options, Inc.*, 2005 U.S. Dist. LEXIS 19891 (E.D. Pa. Sept. 13, 2005) (not a disqualification matter; court implied approval of advance waivers); *Elonex I.P. Holdings, Ltd. v. Apple Computer, Inc.*, 142 F. Supp. 2d 579 (D. Del. 2001); *General Cigar Holdings, Inc. v. Altadis, S.A.*, 144 F. Supp. 2d 1334 (S.D. Fla. 2001) (reviewed by other lawyer; client sophisticated); *In re Rite Aid Corp. Securities Litigation v. Grass*, 139 F. Supp. 2d 649 (E.D. Pa. 2001); *Fisons Corp. v. Atochem N.A., Inc.*, 1990 U.S. Dist. LEXIS 15284 (S.D. Cal. 1990); *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, (S.D.N.Y.) (MacMahon, J) (Memorandum and Order, April 10, 1978); *Interstate Properties v. Pyramid Co.*, 547 F. Supp. 178 (S.D.N.Y. 1982); *West Contra Unified Sch. Dist. v. RDS Architects*, 2004 Cal. App. LEXIS 11726 (Cal. App. Dec. 27, 2004); *Zador Corp. v. Kwan*, 37 Cal. Rptr. 2d 754 (Cal. App. 1995); *Elliott v. McFarland Unified School Dist.*, 165 Cal. App. 3d 562 (Cal. App. 1985); *St. Barnabas Hospital v. New York City Health & Hospitals Corp.*, 775 N.Y.S.2d 9 (N.Y. App. 2004)

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(court enforced advance waiver in litigation even though it did not mention litigation); *Alberta Union of Provincial Employees v. United Nurses of Alberta*, 200 ABQB 33 (CanLII) (Ct. App. Alberta Jan. 23, 2009).

Advance Waiver not Enforced. Concat LP v. Unilever, PLC, 350 F. Supp. 2d 796 (N.D. Cal. 2004) (waiver not specific enough and not discussed with client); *Goss Graphics Systems, Inc. v. Man Roland Druckmaschinen Aktiengesellschaft*, 2000 U.S. Dist. LEXIS 18100 (N.D. Ia. 2000) (conflict regarding which document applied; court resolved in favor of disqualification); *Worldspan L.P. v. The Sabre Group Holdings, Inc.*, 5 F. Supp. 2d 1356 (N.D. Ga. 1998) (waiver failed to mention litigation and too remote in time; court seemed highly skeptical of such waivers); *Florida Ins. Guaranty Ass'n. Inc. v. Carey Canada, Inc.*, 749 F. Supp. 255 (S.D. Fla. 1990); *Marketti v. Fitzsimmons*, 373 F. Supp. 637 (W.D. Wisc. 1974) (mere knowledge by client of second representation not a waiver); *In re Boone*, 83 F. 944 (N.D. Cal. 1897); *All American Semiconductor, Inc. v. Hynix Semiconductor, Inc.*, C 07-1200 (N.D. Cal. Dec. 18, 2008); *Hasco, Inc. v. Roche*, 700 N.E.2d 768 (Ill. App. 1998); *Ulico Cas. Co. v. Wilson, Elser, Moskowitz, Edelman & Dicker*, 843 N.Y.S.2d 749 (N.Y. S. Ct. 2007) (insufficient disclosure).

For Discussion

In re Meridian Automotive Systems-Composite Operations, Inc., et al., 340 B.R. 740 (Bankr. D. Del. 2006). Background: Stanfield Capital Partners, LLC (“Stanfield”) held pre-petition secured debt of Meridian Automotive Systems-Composite Operations, Inc. and its affiliates (the “Debtors”) secured by both first and second liens on the Debtors’ assets.

In October 2004, Stanfield hired Milbank, Tweed, Hadley & McCloy LLP (“Milbank”) to analyze the credit agreements it had entered into with the Debtors, including the intercreditor agreement, related to the debt for the purpose of identifying provisions that might affect the second lien lenders’ plan to provide additional financing to the Debtors secured by first-priority liens in accounts receivable.

In March 2005, an e-mail exchange between Stanfield and Milbank was deemed to have terminated Milbank’s engagement.

In April 2005, in anticipation for filing bankruptcy, the Debtors obtained a commitment for a DIP facility that would pay off the first lien debt in full (the “Take-Out Facility”). An informal committee of first lien holders (the “FLC”) was formed which hired Milbank as its counsel. The Debtors were unable to meet certain conditions necessary to obtain final approval of the Take Out Facility and on June 30, 2005, obtained approval of a priming facility that primed both tranches of debt.

The Court that between June 2005 through February 2006, Stanfield had raised concerns of Milbank’s representation of the FLC. In February 2006, Stanfield filed its motion to

disqualify Milbank pursuant to Profession Conduct Rules 1.7 and 1.9.

The Court found no violation of Model Rule 1.7 because the engagement of Milbank had been terminated in March 2005, prior to Milbank's engagement with FLC. Thereafter, there was no concurrent conflict. Model Rule 1.9, however, requires a duty to former clients and 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.**” (emphasis added)

Notwithstanding Milbank's attempts to distinguish its representation of Stanfield and the FLC as discrete and separate matters, the Court concluded that Milbank's prior representation of Stanfield and its current representation of FLC were substantially related matters in which the parties interests were materially adverse. The Court further rejected Milbank's arguments that Milbank had received express consent or implied consent, or that Stanfield had waived its right to seek disqualification, or that Milbank relied in good faith on its internal conflicts opinion on the matter.

Query whether Stanfield's motion to disqualify Milbank's representation of FLC would have been denied had Milbank obtained a prospective waiver in its engagement letter with Stanfield. How much detail would the Court have required in the prospective waiver to constitute informed consent in satisfaction of Model Rule 1.9 and Model Rule 1.0(e)?

Representing Small Business Debtors and Shareholders – Ethical Pitfalls

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I. What is a small business debtor?

Traditionally, the Small Business Administration (the “SBA”) has defined what businesses are small and, therefore, eligible for SBA loans. Under the SBA rubric, each industry is separately classified and, for example, while a grape producer business is small if its revenues are \$750,000 a year or less, a supermarket is small if the revenues are \$23,000,000 a year or less. Still other industries are classified by the number of employees (an environmental remediation service business is small if it has 500 employees or less).

However, BAPCPA provides a definition of small businesses, which are defined in 11 U.S.C. §101(51)(D) as:

(51D) The term "small business debtor"--

(A) subject to subparagraph (B), means a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate noncontingent, liquidated secured and unsecured debts as of the date of the petition or the order for relief in an amount not more than \$3,000,000 (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor; and

(B) does not include any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than \$3,000,000 (excluding debt owed to 1 or more affiliates or insiders).

Small business cases do not have creditors’ committees, and are often “fast tracked”, with very short timelines. This makes it easier for the debtor to control its own case, but also means that a debtor must file the case with a strategic plan

already in place. Otherwise, the case will quickly run up against deadlines and fail.

II. What happens when the small business is closely held or family-owned? What are the potential problems and pitfalls?

Advising a small business that is family-owned is difficult. The owners will often be deeply emotionally attached to the business. This may make it difficult for them to make decisions that are in the business's best interest.

One of the goals of a bankruptcy (especially a Chapter 11) is to fix a "broken" company. This may be difficult for a small business that is family-owned. For example, one of the owners (who is also a family member), may be the cause of the problem – overordering product, failing to account for transactions properly, or taking other inappropriate actions. However, the other owners may be reluctant to take action, because of the family component.

It also may be difficult for counsel to convince the owners that drastic action is needed – "this is the way we've always done it, and we'll recover". Property or equipment may be leased from other family members, and even if the terms are not economically advantageous, the owners may not be willing to renegotiate or reject when necessary.

The owners also may be distracted by creditor actions against them personally, and may try to resolve these actions in ways that are in conflict with the best interests of the business entity. It may be difficult for the owners to understand their fiduciary duty to maximize the value of the debtor for creditors.

For example, the debtor may receive a sale offer, which would be sufficient to pay all unsecured creditors in full, but which would not provide more than a small dividend to the owners. The owners may choose, in spite of legal advice to the contrary, to reject the offer in order to get more money personally. They may also engage in self-dealing – using company money for personal expenses, failing to distinguish between reimbursements that are permitted (expenses from a business trip) and expenses that are not (expenses from a personal vacation). Indeed, they may not understand that this is inappropriate.

What is the solution? Continually advise the shareholder (who is often, although not always, the client contact) that he or she has a fiduciary duty, and that this type of behavior is likely to lead to trouble. If the conduct does not cease, consider seeking authority to employ an outside Chief Restructuring Officer as a control, or, in extreme cases, withdraw as counsel.

Decisions that may be in the best interest of the company may not be made, or may be made too late, as personal considerations interfere. The

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shareholders may be focused on decisions that minimize their personal risk, which may not be in the best interests of the debtor's creditors. Record keeping may be poor or nonexistent, with numerous insider transactions, loans and payments to family members, and cash transactions with no backup. The owners may be reluctant to pursue causes of action against family members to recover inappropriately disbursed funds or may deny that any such transactions took place. The risk in this situation comes if a creditor or the United States Trustee successfully moves to convert the case. If that occurs, not only may the family members be subject to lawsuits, but the owners could be as well for violations of their fiduciary duty.

III. What happens if the case is converted? What are some of the potential problems?

The Trustee may have an action against the shareholders for violation of fiduciary duty. Depending on how payments were made before and during the chapter 11 case, the Trustee may also have a claim against the shareholders for waste of corporate assets, fraudulent transfers, insider transactions and the like.

Items may be titled in the business's name, but used by the owners personally, like company vehicles. Upon conversion, the owners may not understand that they may not continue to use these items unless arrangements are made with the Trustee.

Once a case is converted (or if is filed as a chapter 7 case to begin with), the owners may have a distorted view of how much assistance you, as debtor's counsel, can give. The owners may not understand that upon conversion, all assets belong to the Trustee, and the disposition of those assets is at the Trustee's discretion.

IV. What happens if the company's owners/shareholders are also personal guarantors of the company's debt?

Is it a conflict if an attorney represents a debtor company and an owner/shareholder in a personal guaranty lawsuit? A bankruptcy attorney has a duty to disclose any potential conflict of interest, and to zealously represent his or her client. How can an attorney zealously represent both an owner/guarantor and a debtor/obligor? This situation clearly creates a conflict, as a successful defense to a guaranty action would lower or eliminate the claim against the guarantor while simultaneously increasing the claim against the company. More obvious conflicts would be representation of an owner who may have looted the company, wasted company assets or otherwise misused company assets. In that case, the conflict is clear, as any recovery against the owner would directly benefit the company's creditors.

Representing Multiple Parties

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1. General Rules on Professional Employment

Professionals retained by a debtor or creditors' committee have to meet rigorous conflict of interest standards before their employment may be authorized by the Court in a bankruptcy case. Bankruptcy Code section 327(a) creates a two pronged test that proposed debtor's counsel must meet. The debtor-in-possession or trustee, may employ one or more attorneys (a) "that do not hold or represent an interest adverse to the estate," and (b) "that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title." 11 U.S.C. §327(a).

The adverse and disinterestedness requirements are intended to "serve the important policy of ensuring that all professionals appointed pursuant to Section 327(a) tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities." *Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994).

Section 327(c) provides further clarification that "a person is not disqualified from employment under this section solely because of such person's employment by or representation of a creditor unless... there is an actual conflict of interest." 11 U.S.C. §327(c). But while the Bankruptcy Code defines who is a "disinterested person" there is no explanation as to what is an adverse interest.

Counsel to a creditors' committee must also pass the disinterestedness and adverse tests. Bankruptcy Code section 1102, which authorizes committee counsel's employment only mentions the adverse test. "An attorney or accountant 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." 11 U.S.C. 1103(b). But the Court will not allow a committee counsel's fees if "such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed." 11 U.S.C. §328(c). Accordingly, the two-prong test in section 327(a) apply to both counsel for the debtor and a committee.

2. Debtor Representations

There are several scenarios in which a debtor's counsel may be faced with potential conflicts issues dealing with a dual representation in a bankruptcy case. Conflicts issues dealing with dual representations not only may involve representing multiple parties, but may also be implied when representing a corporation or partnership in bankruptcy.

a. Multiple Debtors

It is not uncommon for a debtor's affiliates to also file for bankruptcy relief. There are inherent efficiencies for a debtor and its affiliates to retain the same counsel. But counsel for multiple related debtors must carefully evaluate potential intra-estate conflicts between affiliate debtors.

Most courts have avoided a *per se* rule governing conflicts when representing multiple debtors, instead adopting a case-by-case analysis. "The case law generated in connection with multiple representation of related bankruptcy estates establishes that courts have generally declined to formulate bright-line rules concerning the criteria for disqualification but have favored instead an approach which gives the bankruptcy court discretion to evaluate each case on its facts, taking all circumstances into account." *In re BH&P Inc.*, 949 F.2d 1300, 1316 (3d Cir. 1991); *see also In re International Oil Company*, 427 F.2d 186, 187 (2d Cir. 1970) (record which showed existence of intercompany claims was not "sufficient to saddle ... estates [of four affiliated corporations] with the expense of separate ... trustees' attorneys at the present time"); *In re Star Broadcasting*, 81 B.R. 835, 844 (Bankr. D. N.J. 1988) (invariably requiring different counsel in related Chapter 11 proceedings would be unreasonable and unnecessarily cumbersome; whether a disqualifying conflict exists must be considered in light of the particular facts of each case); *In re Global Marine, Inc.*, 108 B.R. 998, 1004 (Bankr. S.D. Tex. 1987) ("mere existence of an intercompany claim does not in and of itself constitute an impermissible conflict of interest that would justify disqualification or denial of compensation").

When potential conflicts between debtor affiliates exist, disqualification may not always be necessary. Special counsel may be hired to handle certain matters. *Global Marine*, 108 B.R. at 1004. In *Adelphia*, a case involving over 200 related debtors, one creditor group sought to bar debtors' counsel from handling intercompany disputes. The Second Circuit observed that employing independent counsel would "burden [the] estates with unjustified and insurmountable costs." *In re Adelphia Communications Corp.*, 342 B.R. 122, 128 (S.D.N.Y. 2006). Ultimately, the parties agreed on a protocol to resolve intercompany disputes.

A few courts have adopted a *per se* rule against the same counsel representing multiple debtors who have claims against each other. *In re Green Street*, 132 B.R. 460 (Bankr. D. Utah 1991) ("existence of a prepetition debt from one estate to the other creates a disqualifying interest"), *subsequently aff'd*, 23 F.3d 311 (10th Cir. 1994); *In re Wheatfield Business Park LLC*, 286 B.R. 412 (Bankr. C.D. Cal. 1002); *In re Lee*, 94 B.R. 172 (Bankr. C.D. Cal. 1998) (adopting a *per se* rule for most related cases).

b. Creditors and Equity Holders

A debtor who becomes a debtor-in-possession upon filing a chapter 11 petition for relief, is granted the same duties and powers usually held by a trustee. *See* 11 U.S.C. §1107. The debtor-in-possession has a fiduciary duty to both its creditors and equity security holders. Counsel to the debtor-in-possession, however, owes duties of

loyalty and care only to its client, not the client's beneficiaries. *ABA Comm. On Ethics and Prof. Resp. Formal Op.* 380 (1994). “[T]here is no provision in the Bankruptcy Code which imposes on counsel for debtor-in-possession fiduciary duties to creditors and shareholders.” *Hansen, Jones & Leta v. Segal*, 220 B.R. 434, 461 (D. Utah 1998); see also *ICM Notes, Ltd. v. Andrews & Kurth, LLP*, 278 B.R. 117 (S.D. Tex. 2002), aff’d, 324 F.3d 768 (5th Cir. 2003); *Berg & Berg Enterprises, LLC v. Sherwood Partners, Inc.*, 131 Cal. App. 4th 802, 32 Cal. Rptr. 3d 325 (6th Dist. 2005), as modified on denial of reh’g. (Aug. 25, 2005) (counsel for assignee in assignment for benefit of creditors does not owe duty to beneficiaries).

While the courts have not found that counsel to the debtor-in-possession has a direct duty to creditors and equity holders, it may have an indirect responsibility to these constituencies. When the debtor-in-possession has been found to have breached fiduciary duties, courts have also found that counsel also breached fiduciary duties to the client under specific circumstances. *In re Count Liberty, LLC*, 370 B.R. 259 (Bankr C.D. Cal. 2007).

c. Insiders

Counsel to a corporation or partnership in bankruptcy face similar ethical challenges confronted by general corporate counsel when the interest held by the corporation or partnership diverge from the interest held by the insiders. Debtor’s counsel is employed by the organization – the debtor-in-possession – not the individual officers and directors. *Hansen, Jones*, 220 B.R. at 453. But the debtor-in-possession is controlled by insiders (officers and directors, and sometimes certain controlling shareholders). And insiders’ influence can create competing allegiances.

The debtor-in-possession and its constituents are not required to be disinterested. See *In re Water’s Edge Ltd. Partnership*, 251 B.R. 1 (Bankr. D. Mass. 2000). It is generally recognized that insiders who control the debtor-in-possession may have their own agenda. Management, however, continues to have a fiduciary duty to its constituents, which in the bankruptcy context have expanded from shareholders to also include creditors. *Commodity Futures Trading Comm’n v. Weintraub*, 471 U.S. 343, 355-56, 105 S.Ct. 1986 (1985).

The potential conflicts arising when the organization’s interests compete with those held by its managers and insiders is exacerbated in the closely held corporation context. Often the debtor may have only one or a few shareholders. *Tetzlaff v. Paro*, 31 B.R. 560, 562-63 (Bankr. E.D. Wis. 1983) (citing *Bobbitt v. Victorian House, Inc.*, 545 F.Supp. 1124, 1126 (N.D. Ill. 1982) (recognizing that it may be difficult “to draw the line between individual and corporate representation.”). While technically employed by the debtor organization, in fact, counsel will also be advising and acting at the sole shareholder’s direction.

When Conflicts Arise

Courts have scrutinized potential conflicts more closely when proposed debtor's counsel represented an insider or the organization before the bankruptcy filing. *See e.g., In re AFI Holding, Inc.*, 355 B.R. 139 (BAP 9th Cir. 2006)(trustee's counsel disqualified for representing insiders before bankruptcy under particular circumstances in case).

Courts have not adopted a *per se* rule barring employment when counsel represented a shareholder. *In re Huntco, Inc.*, 288 B.R. 229 234 (Bankr. E.D. MO. 2002) (most courts have held that representing principal shareholders is not a *per se* adverse interest); *see also, In re Freedom Solar Center, Inc.*, 776 F.2d 14, 17 (1st Cir. 1985); *In re EWC, Inc.*, 138 B.R. 276, 284 (Bankr. W.D. Okla. 1992); *but see In re Kendavis Indus. Int'l*, 91 B.R. 742, 754 (Bankr. N.D. Tex. 1988) (holding that principal shareholder's interest is *per se* adverse to estate). Courts look to the economic interests involved and the facts in the particular case. *Huntco*, 288 B.R. at 234-355 (section 327(a) provides "the bankruptcy court the flexibility to analyze the economic realities underlying the relationship between the shareholders and the debtor in possession").

Representing a debtor and an insider with adverse interests is generally not allowed. *See e.g., Freedom Solar*, 776 F.2d at 18 (counsel to debtor-in-possession may not also represent sole shareholder attempting to buy estate's assets); *Hansen, Jones & Leta*, 220 B.R. at 469 ("representing principals of the debtor-in-possession would lack the disinterestedness required by Section 327, because counsel for the debtor-in-possession owes his allegiance to the debtor-in-possession and not its shareholders, directors, officers, or other constituents."); *Fellheimer, Eichen & Braverman, PC v. Charter Technologies, Inc.*, 57 F.3d 1215, 1229 (3d Cir. 1995); *In re Neidig Corp*, 113 B.R. 696 (D. Colo. 1990) (counsel not allowed to jointly represent debtor-in-possession and principal shareholder). A conflict has been found when counsel represented the debtor and also a controlling shareholder and a separate company set up by the shareholder to acquire the estate's assets. *Freedom Solar*, 776 F.2d at 14. A conflict has also been found when counsel represented the debtor and certain shareholders subject to potential recovery actions.

The more convoluted analysis (and more likely to be faced by a prospective debtor's counsel) arises when the directions given debtor counsel by management appear to diverge from the interests held by creditors and equity holders. Counsel has been sanctioned when found to have acted for an insider's benefit at creditors' and equity holders' expense. *In re Golden Recipe Chicken, Inc.*, 109 B.R. 692, 693 (Bankr. W.D. Penn. 1990)("To the extent that the attorneys for the corporate debtor spent time and energy securing the release of liability [through a chapter 11 plan] for one of the shareholders, they were representing that shareholder.")

Counsel's Duties

Counsel's duty is to the debtor-in-possession organization. These duties and responsibilities do not directly extend to creditors or shareholders. *See e.g.*, ICH Notes, 278 B.R. at 123 (while debtor-in-possession may have a duty to “preserve the bankruptcy estate, this duty cannot be extended to justify the imposition of a fiduciary duty running from counsel ... directly to a particular creditor...”); *In re Sidco, Inc.*, 173 B.R. 194 (E.D. Cal. 1994) (rejecting proposition that counsel for debtor-in-possession also represents other parties' interests in bankruptcy case); *In re Wilde Horse Enterprises, Inc.*, 136 B.R. 830, 840 (Bankr. D.D. Cal. 1991). But merely following the client's direction will not shield an attorney from possible discipline and sanctions. *Hansen, Jones & Leta*, 220 B.R. at 466 (representing “the interest of insiders or principals of the debtor-in-possession to the exclusion of other constituents, generally creditors, not only breaches his/her fiduciary duty to the client debtor-in-possession but does not perform services which are ‘reasonably likely to benefit the debtors estate,’ and therefore is not entitled to compensation for those services.”) (*quoting In re Spanjer Brothers, Inc.*, 191 B.R. 738 (Bankr. N.D. Ill. 1996)).

Counsel has an independent duty to advise and warn the debtor-in-possession, who has a fiduciary duty to creditors and shareholders, about possible actions benefiting insiders without conferring any discernable benefit to creditors or shareholders. *See, e.g.*, *Zeisler & Zeisler, PC v. Prudential Ins. Co. of America (In re JLM, Inc.)*, 210 B.R. 19, 26 (BAP 2nd Cir. 1997) (“The debtor's attorney, while not a trustee, nevertheless is charged with the duty of counseling the debtor in possession to comply with its duties and obligations under the law.”); *Wilde Horse Enterprises*, 136 B.R. at 840 (“... the duty to advise the client goes beyond responding the client's requests for advice. It requires an active concern for the interest of the estate, and its beneficiaries, the unsecured creditors.”); *Hansen, Jones & Leta*, 220 B.R. at 464.

Moreover, counsel has an independent duty to not take actions requested by management, when they are clearly meant to benefit insiders and not creditors and shareholders and such actions are not reasonably likely to benefit the estate.

Under no circumstances, however, may the lawyer for a bankruptcy estate pursue a course of action, unless he has determined in good faith and as an exercise of his professional judgment that the course complies with the Bankruptcy Code and serves the best interest of the estate.

Everett v. Perez (In re Perez), 30 F.3d 1209, 1219 (9th Cir. 1994).

For example, counsel was not awarded fees for prosecuting a debtor-sponsored plan that could not succeed because certain constituents, holding more than 50% of the indebtedness in the case, had informed the debtor and the court that they believed the case should be converted to chapter 7. *Andrews & Kurth LLP v. Family Snacks, Inc. (In re Pro-Snax Distributors, Inc.)*, 157 F.3d 414, 426 (5th Cir. 1998). *See also, Rubner & Kutner v. U.S. Trustee (In re Lederman Enterprises, Inc.)*, 997 F.2d 1321,

1323-24 (10th Cir. 1993) (debtor's inability to develop a confirmable plan should have been apparent to counsel from commencement of the case and accordingly fees for such work are not allowed).

In another case, the Tenth Circuit upheld the denial of fees for counsel who had filed an action taken by the debtor against the creditors' committee solely as a means to delay the committee from taking action to remove existing debtor management, because, in part, counsel's actions did not benefit creditors or equity. *Fellheimer, Eichen & Braverman, PC v. Charter Technologies, Inc.*, 57 F.3d 1215, 1229-30 (10th Cir. 1995). But another court allowed fees when debtor's counsel defended but lost a motion to convert. *JLM, Inc.*, 210 B.R. at 25 (as long as there is a reasonable basis to oppose a motion to convert, compensation will not be denied).

In addition, counsel has a duty to apprise the court. *See Wilde Horse Enterprises*, 136 B.R. at 840. If the debtor client will not follow counsel's advice, depending upon the circumstances, the court may need to be notified. *JLM, Inc.*, 210 B.R. at 26 (counsel has to do more than simply resign, informing the court when debtor-in-possession not meeting fiduciary obligations); *Agresti v. Rosenkranz (In re United Utensils Corp.)*, 141 B.R. 306, 309 (Bankr. W.D. Pa. 1992) (duty to inform court when debtor-in-possession not fulfilling duties); *In re Vining v. Ward (In re Ward)*, 894 F.2d 771, 776 (attorney has duty to inform court).

3. Creditor Representations

a. Representing a Committee, Other Creditors and Committee Members

Counsel to a creditors' committee has a duty to all creditors in the class that the committee represents. The duty to a creditor class arises whether the counsel represents an official statutorily appointed committee or an ad hoc committee. *In re Mirant Corp.*, 334 B.R. 787, 793 (Bankr. N.D. Tex. 2005) ("when a party purports to act for the benefit of a class, the party assumes a fiduciary role as to the class").

Counsel may not hold or represent an interest adverse to the creditor class that counsel represents. *See* 11 U.S.C. 328(c); *see also In re Electro-Optix, U.S.A., Inc.*, 130 B.R. 621, 623 (Bankr. S.D. Fl. 1991) (representing an admin creditor as well as committee not permitted). But representing "one or more creditors of the same class as represented by the committee shall not *per se* constitute the representation of an adverse interest." 11 U.S.C. §1103(b); *see also In re Whitman*, 101 B.R. 37, 38 (Bankr. N.D. Ind. 1989) (representing both a deficiency claim creditor and unsecured creditors' committee not permitted as impermissible conflict).

Firms representing a creditors' committee have simultaneously represented individual creditors and committee members. *See e.g., In re National Century Financial Enterprises, Inc.*, 298 B.R. 112, 118 (Bankr. S.D. Ohio, 2003) (representing committee and committee members allowed); *In re Walnut Equipment*

Leasing Company, Inc., 213 B.R. 285, 290 (Bankr. E.D. Penn, 1997) (allowing committee to employ counsel who also represented committee chairperson); *In re Rusty Jones, Inc.*, 107 B.R. 161, 163-64 (Bankr. N.D. Ill. 1989) (allowing committee to employ counsel who also represented certain individual creditors). These multiple representations, however, are problematic. For example, a committee’s fiduciary duties are to the creditor body as a whole. Accordingly, committees have sued individual creditors in the creditor class, which could result in the committee’s counsel representing an adverse interest.

b. Representing Multiple Creditors

Counsel may represent two or more creditors in the same class. Consent to the joint representation and other steps in accordance with local ethical rules and guidelines would need to be met. Proposed counsel also must disclose any multiple representations with the court. *See* Bankr. R. Pro. 2019(a).

4. Disclosure

Necessary to Disclose Actual and Potential Conflicts

To be employed, both counsel for a debtor and a committee are required to make a broad disclosure to the court about potential conflicts of interest. The general ethical rule has been that appropriate disclosures and a waiver by and among affected parties would suffice. In a bankruptcy case, applicants to represent a debtor or a committee are required to disclose “to the best of the applicant’s knowledge, all of the person’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.” Bankruptcy Rule 2014(a).

The duty to disclose potential conflicts continues throughout the case and a professional must promptly file an amended disclosure with the Court. Section 328(c)’s reiteration that professionals must be disinterested and have no adverse interests acts retrospectively in a case, imposing the requirement that such professional disclose potentially new conflicts with the Court. *See In re Diamond Mortgage Corp.*, 135 B.R. 78, 89 (Bankr. N.D. Ill. 1991).

Failure to disclose can have serious repercussions. *See e.g., Hansen, Jones & Leta*, 220 B.R. at 469 (“The disclosure rules impose an independent responsibility upon counsel.”); *In re Park-Helena Corp.*, 63 F.3d 877, 880 (9th Cir. 1995), *cert. denied*, 516 U.S. 1049, 116 S.Ct. 712 (1996) (failure to disclose is sanctionable); *In re EWC, Inc.*, 138 B.R. 276, 280 (Bankr. W.D. Okla. 1992) (failure to disclose sufficient to deny all compensation); *JLM, Inc.*, 210 B.R. at 24 (fees may be denied for failure to disclose).

Furthermore, as earlier referenced in this presentation, attorneys hired by multiple creditors or who represent ad hoc committees are required to make broad disclosure about each individual creditor whom they represent. Counsel who represents “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 interest owned by the entity, the members of the committee or the indenture trustee, the times when acquired, the amounts paid thereof, and any sales or other disposition thereof....” Bankruptcy Rule 2019(a).

Bankruptcy Rule 2019(b) also provides specific sanctions for persons who do not comply with the Rule’s disclosure requirements. The Court may “refuse to permit that entity, committee, or indenture trustee to be heard further or to intervene in the case....” Bankruptcy Rule 2019(b).

5. Sanctions

Counsel may be subject to wide ranging sanctions when found to have either failed to disclose a conflict or breached fiduciary duties. Typically fees may be denied for certain actions taken by counsel when no clear benefit for the estate has been established. *Fellheimer, Eichen & Braverman*, 57 F.3d at 1228 (bankruptcy court has authority to deny counsel’s fees when found that counsel held interest adverse to estate). Courts have also denied fees completely and ordered that previously awarded fees be disgorged. *In re Bonneville Pacific Corp.*, 147 B.R. 803, 806 (Bankr. D. Utah 1992) (disgorgement may be allowed when found that fees awarded under interim procedure when attorney misrepresented facts).

For serious violations, counsel may also be subject to sanctions by the Court. Sanctions can include monetary penalties. In the most severe cases, counsel could be barred from appearing before the Court or referred to the bar for disciplinary action.