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M E M O R A N D U M

PROFESSIONAL COMPENSATION

Current Trends and Perspectives in Connection with
the Retention and Employment of Professional Persons
Under the Bankruptcy Code

DECISIONS ON RULE 2014 DISCLOSURE
AND SANCTIONS FOR FAILURE TO DISCLOSE

I. In re El Commandante Mgmt. Co., LLC, 395 B.R. 807 (D. P.R. 2008)

A. Background

In El Commandante, the Plan Administrator (the “Appellant”) filed a motion requesting disgorgement of all fees and expenses incurred by Debtor’s counsel (the “Appellee”) in connection with services rendered to the Debtor. The Bankruptcy Court and the Magistrate Judge both denied the Appellant’s request.

The Appellant argued the Appellee had a conflict of interest from at least November 23, 2005, which remained undisclosed until January 2007, when Appellee filed a motion withdrawing as Debtor’s counsel. On November 23, 2005, FirstBank issued a financing commitment to Camerero Race Track Corp. (“Camerero”) for the purpose of acquiring the Debtor’s assets, which occurred on January 4, 2007 pursuant to a confirmed plan. The Appellee represented FirstBank in matters unrelated to the bankruptcy proceedings. Appellant claimed that all fees and expenses paid since November 23, 2005 should be disgorged, as they were incurred while working under an undisclosed conflict of interest. This potential conflict of interest became an actual one when an asset sale was proposed (the “Asset Sale Plan”) as an alternative to the Debtor’s Plan of Reorganization.

B. Discussion

Appellant argued that the Appellee had a duty to disclose the conflict of interest and that FirstBank was a party in interest because it was a creditor of the estate and had a substantial interest in the outcome of the case. The Appellant asserted that: (1) FirstBank became a creditor when it filed a proof of claim, and (2) FirstBank became a party in interest when it acquired the right to grant Camerero the \$60M loan as part of the Asset Sale Plan. The Appellant argued that the Appellee's failure to disclose its relationship with FirstBank was a violation of its fiduciary duties under FRBP 2014, warranting the denial of compensation and the disgorgement of all fees and expenses.

In order to determine whether the Appellee complied with FRBP 2014, the court had to determine whether FirstBank was a party in interest. The Appellant argued that FirstBank filed a proof of claim (which qualified it as a creditor) and that FirstBank appeared twice on the Master List (on which only creditors and parties in interest were listed). However, this evidence was not offered to the bankruptcy court, and the district court could not review evidence if it was proffered for the first time at the appellate setting.

The court next looked to Section 327 to determine if there was a conflict of interest. Attorneys employed as bankruptcy professionals must be "disinterested" and hold no "interest materially adverse to the interest of the estate." This is a fact-specific inquiry by the bankruptcy court, reviewed for clear error. The Appellant argued that FirstBank's loan commitment with Camerero made it a party in interest because it had an economic interest in the outcome of the case. The Debtor's Plan of Reorganization proposed that the Debtor would keep its assets. This was alleged to create a conflict of interest, as the Appellee would have to oppose the Asset Sale Plan supported by FirstBank.

The court found that FirstBank's relationship with Camerero made it a mere observer of the proceedings waiting to see if its potential client would need the credit offered. FirstBank was represented by different counsel in the proceedings. The Bankruptcy Court found that the Appellee demonstrated undivided loyalty to the Debtor. The District Court found that the Bankruptcy Judge is in the best position to judge the facts and determine if a conflict of interest exists.

C. Conclusion

The court could find no reason to disturb the Bankruptcy Court's judgment. The District Court adopted the Magistrate Judge's recommendation that the Bankruptcy Court's decision be affirmed. The Appellant's request that the fees and expenses requested by the Appellee be denied and that fees and expenses previously paid be disgorged was denied.

II. In re Global Marine, Inc., 108 B.R. 998 (Bankr. S.D. Tex. 1987).

A. Background

In Global Marine, Global Marine, Inc. ("GMI") and its 13 subsidiaries, including Global Marine Deepwater Drilling, Inc. ("GMDDI"), were parties to jointly administered Chapter 11 cases and, with the exception of one subsidiary, were being represented by the law

firm of Weil, Gotshal & Manges (“WGM”). Approximately \$1 billion was owed in intercompany debts among the affiliates. GMI owed GMDDI approximately \$170 million. It was the existence of this intercompany claim that MCCC Corp. (“MCCC”) alleged constituted an impermissible conflict of interest.

B. Discussion

1. Disqualification

The court first considered whether WGM should be disqualified from the representation of GMI or GMDDI. The court noted that section 372(c) provides that a professional is not disqualified solely because of the representation of a creditor unless there is an actual conflict of interest. There is no bright line rule in the Fifth Circuit stating that a professional cannot represent both the controlled and controlling entity.

The court found that there was a unity of ownership and guaranteed obligations between GMI and GMDDI. The unity of interests, together with the particular facts of the case, categorized the matter as a situation in which dual representation did not create a disqualifying conflict. The court also found that the presence of an intercompany claim is not a per se actual conflict of interest. The court also noted that conflict of interest analysis is fact-intensive. The court found that there was a fundamental distinction between “potential” conflicting interests that may arise in joint representation and an “actual conflict of interest” as envisioned by section 327.

The Debtors had a unity of interest and singleness of purpose, and both the chief financial officer of GMI and vice president of GMDDI testified that only one group of attorneys was desired in order to avoid the duplication of fees that would result with multiple firms representing more than a dozen affiliated parties. The officers also testified that the only way for GMI to survive was for the subsidiaries to thrive. Moreover, MCCC could not show any instance of actual injury due to the dual representation. The court found that while there was a potential for conflict, the mere existence of the intercompany claim between GMI and GMDDI did not elevate the situation to one of an actual conflict of interest disqualifying WGM from representing either GMI or GMDDI. The court would not act in a preemptive manner, as doing so would result in interruption of the orderly administration of the Debtors’ bankruptcy proceedings.

C. Conclusion

The court found that WGM’s dual representation of GMI and GMDDI did not result in an actual conflict of interest which would require a reduction or denial of WGM’s fees. Accordingly, the court denied the motion.

III. In re EToys, Inc., 331 B.R. 176 (Bankr. D. Del. 2005).

A. Background

In EToys, the court ruled on Motions filed by a shareholder, Robert Alber (“Alber”), and an administrative claimant, Collateral Logistics, Inc. (“CLI”), against Barry Gold (“Gold”), Debtor’s counsel, and Committee counsel, and certain of their partners

(collectively, the “Respondents”) seeking removal, disgorgement of fees, and sanctions for violations of FRBP 2014 and section 327. The United States Trustee (the “UST”) sought approval of a settlement between the UST and Committee counsel of a motion requesting the disgorgement of fees from Committee counsel. A motion seeking approval of a settlement with Goldman Sachs & Co. (“Goldman”) was also pending before the court.

On March 7, 2001 (the “Petition Date”), eToys, Inc., and certain of its affiliates (collectively, the “Debtors”) filed for relief under Chapter 11. On April 5, 2001, the Debtors filed an application to retain Debtor’s counsel as their bankruptcy attorneys. In connection with the Debtor’s counsel retention application, a partner at Debtor’s counsel submitted an affidavit listing parties in interest it had represented over the preceding three years. The affidavit failed to disclose that Debtor’s counsel was representing General Electric Capital Corporation (“GECC”) and two affiliates of Goldman (the “Goldman Affiliates”) in a bankruptcy case filed by Finova Capital Corporation (“Finova”) on the same day the Debtors filed their case. No objections were filed to the Debtor’s counsel retention application, and the court approved it on April 25, 2001.

On April 25, 2001, the court approved the Official Committee of Unsecured Creditors’ (the “Committee”) retention of Traub, Bonaquist & Fox (“TBF”) as Committee counsel. On May 21, 2001, the Debtors hired Gold to coordinate their liquidation, and on July 23, 2001, Gold was named the Debtors’ President and CEO.

On November 1, 2002, the court confirmed the Plan, pursuant to which the Debtors’ remaining assets were vested in EBCI, Inc. (the “Reorganized Debtor”). Gold was appointed Plan Administrator and managed the Reorganized Debtor. Gold retained Debtor’s counsel as counsel for the Reorganized Debtor. The Committee was dissolved and succeeded by the Post Effective Date Committee (the “PEDC”). At the time of the court’s ruling on the motions, the liquidation of the Reorganized Debtors’ assets was close to conclusion. The security and priority creditors were to be paid in full, unsecured creditors were to receive a distribution of approximately 16%, and shareholders would receive nothing.

On November 24, 2004, the PEDC filed a motion for approval of a settlement it had reached in a dispute with Goldman. Alber and CLI filed objections to the motion, asserting that there was a conflict of interest between the PEDC, Gold, Debtors’ counsel and Goldman. In late December of 2004, Alber and CLI filed motions for sanctions and related relief against Gold and Committee counsel. Alber filed a motion against Debtor’s counsel seeking disqualification and disgorgement of fees. On February 15, 2005, the UST filed a motion seeking disgorgement of fees from Committee counsel (the “Disgorgement Motion”). The Disgorgement Motion was subsequently settled, and a motion to approve the settlement was filed on February 24, 2005 (the “Settlement Motion.”). Alber and CLI filed pleadings in support of the Disgorgement Motion and in opposition to the Settlement Motion. There was a hearing on all the motions, and the court allowed additional briefing before issuing its decision.

B. Discussion (Debtors’ counsel and its Partners)

Alber’s motion sought the disgorgement of all fees earned by Debtor’s counsel due to the failure to disclose in its retention application that it had a conflict as it was concurrently representing the Goldman Affiliates and GECC in the Finova case. GECC was a

creditor in eToys and the Debtors had claims against Goldman, including litigation that the PEDC was prosecuting at the time of the court's opinion.

Section 327 requires that attorneys employed by the debtors in a bankruptcy case must not hold or represent any adverse interest to the estate and must be disinterested. FRBP 2014 is used to enforce Section 327 by requiring the attorneys to disclose relationships with parties in interest in a case. The duty to disclose under FRBP 2014 is considered sacrosanct. All connections with parties in interest must be disclosed, and the attorney has the ongoing duty to update the disclosures. Failure to disclose is an independent basis for the disallowance of fees.

Prior to the bankruptcy filing, the Debtors had engaged Goldman, which resulted in a dispute that was ongoing on the Petition Date. Debtor's counsel became aware of the dispute sometime after the Petition Date, and at least by May 25, 2001. The dispute was resolved by a Termination Agreement in August 2001; however, by early June 2001, Debtors' counsel admitted that it had knowledge that the Debtors had additional substantial claims against Goldman. Instead of supplementing its disclosures, Debtors' counsel "solved" the problem by ultimately arranging for the Committee to take over the representation of the estate in matters involving Goldman.

On September 26, 2001, the Debtors filed a motion to authorize the Committee to investigate and prosecute any further actions the estate might have had against Goldman. In that motion, Debtors' counsel disclosed that it had represented Goldman in an unrelated matter. The Committee asserted claims against Goldman, and the two sides submitted a settlement motion. Alber objected to the motion, asserting that it was tainted by conflicts of interest.

Alber also alleged that Debtors' counsel's concurrent representation of the Goldman Affiliates and the Debtors created an impermissible conflict of interest, which the firm failed to disclose at the onset of the case and which was not cured by the inadequate subsequent disclosure.

The court acknowledged that the disclosure requirements cannot be so onerous as to create an impossible task. However, disclosure was mandated when there was an actual conflict, beginning in May 2001, when Debtors' counsel learned that the Debtors had a claim against Goldman. Debtors' counsel should have promptly filed a supplemental affidavit disclosing its connection with Goldman and let a disinterested professional handle the matter.

The firm argued that its representation of Goldman in Finova was not a conflict because it was an unrelated case, Debtors' counsel only acted as Delaware counsel, and the case accounted for only 0.24% of the firm's billings from 2000 to 2004. However, the court found that Debtors' counsel continued to represent Goldman in the Finova case and Goldman did not waive the conflict. As Debtors' counsel had an actual conflict of interest, it was not able to represent the Debtors in asserting their claims against Goldman. It was not sufficient that the Debtors authorized the committee to pursue claims against Goldman. This authorization came four months after Debtors' counsel knew there was a conflict. Additionally, the disclosures were required to be made in a supplemental declaration under FRBP 2014, and it was not sufficient that the information could be determined from other sources.

The court found that harm resulted to the estate because of the duplication of effort during the summer of 2001 as Debtors' counsel and the Committee both worked on Goldman claims. However, harm to the estate is not necessary to order disgorgement of fees when there is a conflict of interest. The court ordered the disgorgement of all fees Debtors' counsel earned for its work on matters involving Goldman.

The court found that Debtors' counsel learned that GECC was a creditor when GECC filed a notice of appearance and a motion to compel assumption or rejection in June of 2001. Debtors' counsel did not file any disclosure of its relationship with GECC. Because Debtors' counsel was representing GECC in another case, its representation against GECC in the present case was an actual conflict of interest. It did not matter if the failure to disclose was "inadvertent." There was an actual conflict that was not waived and no disclosure was made. Debtors' counsel was ordered to disgorge the fees it received for its work on behalf of the Debtors in matters involving GECC.

C. Discussion (Committee Counsel)

Alber's motion asserted that Committee counsel should be disqualified as counsel to the PEDC and should be required to disgorge all fees earned while it was counsel to the Committee because of its failure to disclose its relationship with Gold.

In late 2000 or early 2001, Paul Traub and Gold formed Asset Disposition Advisors, LLC ("ADA"), a joint venture for marketing inventory control and asset disposition services to distressed companies. Gold was compensated by ADA at the rate of \$30,000 per month beginning in February 2001. As ADA had not been formed and had no assets at that time, Gold's compensation came from TBF. ADA conducted its business from the offices of Committee counsel. Committee counsel had also retained Gold as a consultant in prior cases.

TBF was retained as counsel by the Committee. Committee counsel recommended Gold to the Debtors for the position of restructuring executive. The Debtors hired Gold as wind-down coordinator, and, after obtaining insurance, as their president and CEO.

Committee counsel had a relationship with an affiliate of FleetBoston, against whom PEDC was pursuing litigation. At no time did Gold or TBF disclose any of these relationships.

The court found that Committee counsel had a direct relationship with Gold, having hired him as a consultant in several cases. Committee counsel admitted that it should have disclosed this relationship when Gold was considered by the Debtors for employment. The court noted that the duty to disclose is broader than the disclosure of actual conflicts. It mandates the disclosure of all connections a professional may have with the other parties in the case. Failure to disclose can result in the disallowance of fees or disqualification, even if the failure was negligent and not willful. When the failure is willful, the disallowance of fees is almost assured.

Because the court was considering the disclosure obligations of counsel to the committee, Section 327 was not applicable and Section 1103 governed. Section 1103 does not

require that counsel be disinterested, but it does require that counsel for the committee not hold or represent any adverse interest in connection with the case. Committee counsel argued that, while the relationships may raise an appearance of a conflict, no actual conflict existed.

The UST Disgorgement Motion was also based on Committee counsel's failure to disclose the relationship it and Paul Traub had with Gold. The UST and Committee counsel settled their dispute over the conflict of interest. The settlement required Committee counsel to disgorge \$750,000 of the fees it received in the case, or approximately half of the total postpetition, preconfirmation fees. In the Third Circuit, to approve a settlement, the court must consider: (1) the probability of success in the litigation, (2) the likely difficulties in collection, (3) the complexity of the litigation, and the expense, inconvenience and delay necessarily attending it, and (4) the paramount interest of the creditors. Because the Disgorgement Motion was a sanctions motion, the court also considered the deterrent value that approval of the settlement would have.

The court found that approval of the settlement was appropriate. There was a risk to both sides if the issue was litigated. The court granted the Settlement Motion and denied the Alber's motion to the extent it sought to impose any additional penalties on Committee counsel.

D. Discussion (Gold)

Alber argued that the relationships among TBF, Paul Traub, Gold, and ADA constituted an actual conflict of interest that had to be disclosed and should have disqualified Gold from being retained by the Debtors. Gold was working on two cases as a consultant to Committee counsel at the time he was hired by the Debtors. Committee counsel was paying Gold \$30,000 a month on behalf of ADA, which put into question Gold's loyalty to the Debtors. Gold argued that because he was hired by the Debtors and not ADA, no conflict requiring disclosure existed.

The court found that Gold only earned compensation from ADA for work performed by ADA. Gold's relationship was with a professional in the case, not a creditor. Neither ADA nor Paul Traub had a direct claim against the Debtors. Committee counsel was counsel to the Committee, so it owed a fiduciary duty to all creditors and could not pressure Gold to promote the interests of one creditor over another. This was also a liquidation case, so the interests of the Debtors and creditors coincided.

The court found that there was a potential conflict between Gold's position as president and CEO of the Debtors and his business relationships with counsel for the Committee. In this case, there was no transaction between the Debtors and ADA that the court could examine. Gold's position as a partner at ADA was not a breach of his duty of loyalty, and there was no evidence that his relationships with Committee counsel and Paul Traub caused him to violate his fiduciary duties.

The court found that an officer is not a professional who needs to be retained by the debtor under Section 327. However, the court ruled that it does have the power to supervise and deny compensation to officers of a debtor in appropriate circumstances. The court found

that, in order for it to perform a proper review, it was necessary for an officer to disclose his relationships with creditors, professionals, and other parties in the case. Gold had not done so.

In its decision, the court established a new rule that an officer's failure to disclose relationships with creditors, professionals and other parties-in-interest will subject that officer to review and possible disgorgement of compensation if the court concludes that the relationship constitutes an actual conflict of interest. The court found that there was no evidence of an actual conflict of interest by Gold that caused harm to the estate, and the court would not reduce Gold's compensation or otherwise sanction him.

IV. In re Adelpia Communications Corp., 336 B.R. 610 (Bankr. S.D. N.Y. 2006)

A. Background

In Adelpia, the Ad Hoc Committee of Arahova Noteholders (the "Arahova Noteholders' Committee") – holders of bond debt issued by Arahova Communications Inc. ("Arahova"), an intermediate subsidiary of Adelpia Communications Corp. ("Adelpia Parent"), one of the 231 debtors (the "Debtors") whose Chapter 11 cases were being jointly administered in the court – moved for orders: (1) appointing a Chapter 11 trustee for Arahova and its operating company subsidiaries (together, the "Arahova Debtors"), or, alternatively, (a) directing the recusal of the Arahova Debtors' officers and directors with respect to interdebtor disputes (the "Interdebtor Disputes"), and (b) ordering the appointment of nonstatutory fiduciaries – "independent" officers and directors – and "unconflicted counsel" to represent the Arahova Debtors in intercreditor disputes (the "Intercreditor Disputes") then pending in the court (the "Trustee Motion"); (2) disqualifying Willkie Farr & Gallagher ("WFG"), counsel representing all of the debtors since the Chapter 11 cases filed 3½ years earlier, from representing the Arahova Debtors or any of the other debtors in the Interdebtor Disputes (the "Disqualification Motion"); and (3) terminating the Arahova Debtors' exclusive right to file a reorganization plan (the "Exclusivity Motion").

The court found that it would be impractical to discuss in detail every finding it could or did make. In the interest of relative brevity, the court omitted citations to the record except for the most significant matters. Notwithstanding this attempt at brevity, the opinion spans 72 pages.

The motions were based on a factual predicate common in multi-debtor Chapter 11 cases. In multi-debtor cases, individual debtors frequently have actual or arguable obligations to each other, by reason (1) money lent, or assets having been transferred, from one debtor to another; (2) one debtor having provided or obtained the services of other debtors; (3) allocations of overhead or charges for shared facilities or other property; or (4) other interdebtor dealings. The motions in the present case raised material issues of fact that required three days of evidentiary hearings.

Adelpia was one of the largest cable companies in the US. Adelpia ran into trouble when it was discovered more than \$2 billion in borrowings that were not reflected on its financial statements, including improper advances to the Debtors' founders. The Debtors filed for Chapter 11 protection in June 2002. At the time of the hearing, 231 cases were being jointly

administered. As part of the first day orders, the court approved the retention of WFG by all of the Debtors to provide them with, *inter alia*, general restructuring advice.

After filing for Chapter 11, the Debtors hired a new CEO, CFO, and COO. In light of the fiscal mismanagement and fraud on the part of the founding family, the Debtors initiated investigations and engaged forensic accountants. The Debtors' accounting personnel initiated an analysis, review, and, in certain cases, reconstruction of Adelpia's historical books and records (the "Restatement"). The Restatement ensured that the Debtors' financial records would be presented in accordance with GAAP, allowing the Debtors to get an audit opinion from PricewaterhouseCoopers LLP. The audited financials would be required by either a potential buyer or the SEC if the Debtors were to emerge as stand-alone companies.

The Debtors learned of issues, such as possible fraudulent conveyances, that could increase or decrease assets or liabilities of one or another of the individual Debtors vis-à-vis each other. Separate financial statements could not be completed for each subsidiary without resolving these issues. In order to complete the Restatement, generate consolidated financial statements, and obtain an audit opinion, the Debtors had to reconcile their balance sheet accounts, including intercompany general ledger accounts. The way in which the Debtors drew conclusions as to the appropriate accounting for Intercompany Transactions was a matter of sharp dispute between some of the creditor groups, particularly the Arahova Noteholders' Committee and the Adelpia Parent Noteholders Committee.

The court, rejecting a contention of the Arahova Noteholders' Committee, found that the Debtors approached the task of accounting for the intercompany transfers with neutrality. An important aspect of the accounting review was to determine what had occurred before the filing. The Debtors made the raw data available, allowing any party to draw its own conclusions, and the Debtors made it clear that their legal and accounting conclusions were not binding on the court. When the Debtors made corrective entries, they made sure that parties could still access the unchanged data. The court found that, though the Debtors knew that the Restatement and its subsequent reconciliation of the Intercompany Transactions would affect recoveries, they were solely motivated by a desire to achieve accuracy in accounting.

Beginning in August 2003, the Debtors convened a series of meetings with key parties to review and discuss the primary factors in determining potential recoveries. The Debtors brought the issues, including the valuation and allocation of Intercompany Transactions, to the attention of the creditors in the hopes that they would consensually resolve them. The Debtors specifically had the precursors to the Arahova Noteholders' Committee and the Adelpia Parent Noteholders Committee come together to attempt to resolve their disputes.

B. Discussion

1. Disqualification of WFG

The Arahova Noteholders' Committee did not seek to disqualify WFG generally. Rather, it sought to disqualify WFG from representing the Arahova Debtors or any of the other debtors in the Interdebtor Disputes. The court granted the motion for essentially the same reason it granted similar relief with respect to the Debtors' officers' recusing themselves from

dealing with intercreditor disputes. That is to say, WFG needed to avoid conflicts of interest in the dealings between one debtor and another.

The court found that WFG had acquired extraordinary expertise in Adelpia affairs, and had performed its responsibilities with distinction. WFG had not been conflicted at the beginning of the cases. However, the intercreditor issues had expanded to the point where they were a prominent feature of the Chapter 11 cases. Because the parties to the Intercreditor Disputes held debt of different debtors in the Adelpia structure, the disputes could also be accurately described as Interdebtor Disputes. Once the Interdebtor Disputes were in litigation, WFG could not act on both sides of a litigated controversy.

The affected creditors already had the knowledge, means, and inclination to litigate the issues, and did not need WFG to do so. WFG could try to facilitate agreement, while at the same time refraining from taking any public role that would cause one or another creditor group to feel that WFG was acting contrary to an individual debtor's interests. The court found that WFG had done nothing wrong, and had remained publicly neutral in trying to facilitate agreement in the Intercreditor Disputes. However, the prophylactic imposition of mandatory neutrality on WFG on interdebtor issues would not cause WFG or the Debtors any material prejudice.

C. Conclusion

In concluding its opinion, the court voiced its displeasure with the Arahova Noteholders' Committee for bringing the motions.

“The bringing of motions like these is not unethical, or sanctionable, but neither should it be encouraged or rewarded. Motions that would bring on intolerable consequences for an estate should not be used as a tactic to augment a particular constituency's recovery. Except for the aspects of this ruling that require the Debtors and their counsel to act as they have already committed to do, these motions are wholly without merit.”