Ethical Rules and Pitfalls for Bankruptcy Practitioners

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Presenter:

Michael J. Riela | *Tannenbaum Helpern Syracuse & Hirschtritt LLP*

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Discussion Topics

- Part I: Conflicts and Disinterestedness Rules: Model Rules of Professional Conduct and Bankruptcy Rules.
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- Part III: Fee Arrangements In Consumer Bankruptcy Cases.

PART I

Conflicts and Disinterestedness Rules: Model Rules of Professional Conduct and Bankruptcy Rules

Model Rule of Professional Conduct 1.7

- Addresses conflicts of interest relating to current clients.
- A lawyer may not represent a client if the representation involves a "concurrent conflict of interest."
- A concurrent conflict of interest exists when:
  - the representation of one client is directly adverse to another client; or
  - 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.

Model Rule of Professional Conduct 1.7 (cont.)

- Exception: A lawyer may represent a client involving a concurrent conflict of interest if:
  - the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
  - the representation is not prohibited by law;
  - 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
  - each affected client gives informed written consent.

Model Rule of Professional Conduct 1.9

- Addresses lawyers' duties to former clients.
- A lawyer who has formerly represented a client may not represent a new client in the same or a substantially related matter, where the new client's interests are materially adverse to the interests of the former client, unless the former client gives informed written consent.
- A lawyer may not knowingly represent a person in the same or a substantially related matter in which the lawyer's former firm had represented a client:
  - whose interests are materially adverse to that person; and
  - about whom the lawyer acquired protected information material to the matter; unless the former client gives informed written consent.

Model Rule of Professional Conduct 1.9 (cont.)

- A lawyer who formerly represented a client in a matter, or whose present or former firm formerly represented a client in a matter, may not thereafter:
  - use information relating to the representation to the disadvantage of the former client except as permitted or required by the Model Rules, or except when the information has become generally known; or
  - reveal information relating to the representation except as these Rules would permit or require with respect to a client.

Model Rule of Professional Conduct 1.10

- Addresses the imputation of conflicts of interest to a firm.
- None of the individual lawyers in a firm may knowingly represent a client if any one of the lawyers practicing alone would be prohibited from doing so by Model Rules 1.7 or 1.9
  - Exception to this rule applies if the prohibition is only based on a personal interest of the prohibited lawyer, and does not present a significant risk of materially limiting the representation of the client by the remaining lawyers in the firm.

Model Rule of Professional Conduct 1.10 (cont.)

- If a lawyer terminated an association with a firm, the firm may represent a person with interests materially adverse to those of a client who was represented by the formerly associated lawyer and not currently represented by the firm, unless:
  - the matter is the same or substantially related to that in which the formerly associated lawyer represented the client; and
  - any lawyer remaining in the firm has protected information that is material to the matter.
- A disqualification prescribed by this Rule may be waived by the affected client by informed written consent.

Model Rule of Professional Conduct 1.13

- Rules that apply when the client is an organization.
- A lawyer for an organization represents the organization itself, and not any individual person in the organization.
- In dealing with an organization's constituents, the organization's lawyer shall explain the identity of the client, when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.
- A lawyer representing an organization may also represent any of its constituents, subject to the provisions of Rule 1.7.

Professional Retention Process in Bankruptcy Cases

Overview of the Bankruptcy Retention Process

- The client (*i.e.*, debtor-in-possession, bankruptcy trustee or official committee) files an application with the bankruptcy court to retain a professional.
- Professional files a Bankruptcy Rule 2014 declaration/affidavit in support of the client's application.
- Parties have an opportunity to object to the application.
- The bankruptcy court holds a hearing on the application, and the client must obtain a bankruptcy court order approving the retention.
- Professional normally needs to file fee applications after it is retained.

Section 327(a) Professionals

- 11 U.S.C. § 327(a) addresses retention of professionals by debtors-in-possession and bankruptcy trustees.
- Section 327(a) of the Bankruptcy Code provides:
  - "Except as otherwise provided in this section, the trustee [or debtor-in-possession], with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that **do not hold or represent an interest adverse to the estate**, and **that are disinterested persons**, to represent or assist the trustee in carrying out the trustee's [or debtor-in-possession's] duties under this title."

Section 327(e) Attorneys

- 11 U.S.C. § 327(e) provides that a bankruptcy trustee or debtor-in-possession may employ, for a specified special purpose, an attorney that has represented the debtor.
  - Technically, only attorneys may be retained under Section 327(e), and such attorneys must have represented the debtor in the past.
  - Such attorneys cannot represent the debtor-in-possession or trustee in conducting the bankruptcy case.
- The special purpose attorney **may not represent or hold any interest adverse to the debtor or to the bankruptcy estate with respect to the matter on which it is to be employed**.

Ordinary Course Professionals

- In some Chapter 11 cases, the bankruptcy court will permit the debtor-in-possession to employ professionals in the ordinary course of business, without the need for a formal retention application and fee applications.
- These professionals' expected fees are modest, and they usually cannot assist in the debtors' reorganization efforts.
- The bankruptcy court typically requires proposed ordinary course professionals to file a declaration/affidavit disclosing their connections with parties in interest.
- Ordinary course professional typically cannot represent or hold any interest adverse to the debtor with respect to the matter on which the professional will be employed.

Section 1103 Committee Professionals

- 11 U.S.C. § 1103 addresses retention of professionals by official committees in Chapter 11 bankruptcy cases.
- Official creditors' committees and official equity committees may employ professionals.
- An attorney or accountant employed to represent an official committee **may not**, while employed by such committee, **represent any other entity having an adverse interest in connection with the case**.
  - Representation of one or more creditors of the same class as represented by the committee does not *per se* constitute the representation of an adverse interest.

Definition of "Disinterested Person"

- A "disinterested person" is one who:
  - is not a creditor, an equity security holder or an insider;
  - is not and was not, within 2 years before the date of the filing of the bankruptcy petition, a director, officer or employee of the debtor; and
  - does not have an interest materially adverse to the interest of the bankruptcy 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.

"Adverse Interest"

- "Adverse interest" is not defined in the Bankruptcy Code.
- Courts generally have defined "adverse interest" to mean:
  - possessing or asserting any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate would be a rival claimant; or
  - possessing or having a predisposition under the circumstances to be biased against the estate.
  - *See, e.g.*, *In re American Intern. Refinery, Inc.*, 676 F.3d 455 (5th Cir. 2012).

The Bankruptcy Rule 2014 Declaration

- Bankruptcy Rule 2014 requires a proposed professional to file a declaration or affidavit disclosing its "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.
- Disclosures must be sufficiently detailed and must be accurate.
- A professional's failure to disclose relevant connections may lead to disqualification from the case, and the disallowance and disgorgement of fees.

The Bankruptcy Rule 2014 Declaration (cont.)

- Under Bankruptcy Rule 2014, proposed professionals must disclose all connections it has with parties-in-interest, regardless of whether such connections are sufficient to rise to the level of a disqualifying interest under Section 327(a).
- Professionals should not determine unilaterally whether a connection is relevant or material enough for disclosure.
- All connections should be disclosed. Penalties for non-disclosure can be severe.
- The bankruptcy court will review the professional's Bankruptcy Rule 2014 declaration, and it will decide whether there are any disqualifying conflicts.

The Bankruptcy Rule 2014 Declaration (cont.)

- The professional should disclose current connections and connections that recently existed (*e.g.*, during the last 2-3 years) between the professional and the parties-in-interest.
- Professionals should also disclose current and recent past connections that could reasonably have an effect on the professional's work and its professional judgment.
- Disclosure is an ongoing responsibility, even after the professional's retention is approved.

The Bankruptcy Rule 2014 Declaration (cont.)

- Other items that should be disclosed in a Bankruptcy Rule 2014 declaration/affidavit include:
  - the amount of any unpaid fees or other prepetition claims;
  - any retainers the professional had received from the debtor or from third parties;
  - payments received by, or promised from, third parties;
  - amounts received during the 90-day "preference period";
  - amounts held by the professional in trust;
  - joint defense agreements that are adverse to the estate;
  - information concerning conflict waivers by major creditors.

Section 328(c) - Sanctions

- 11 U.S.C. § 328(c) provides that the court may deny the fees and expenses of a professional who is employed under section 327 or 1103 of the Bankruptcy Code if, at any time during its employment under section 327 or 1103, the professional was not a "disinterested person," or represented or held an interest adverse to the interest of the estate with respect to the matter on which it was employed.
- The court may order fee disallowance and disgorgement, even if the harm to the bankruptcy estate is minor or non-existent.

Cases Involving Inadequate Disclosure

- *In re Hutch Holdings, Inc.*, 532 B.R. 866 (Bankr. S.D. Ga. 2015).
- *In re GSC Group, Inc.*, 502 B.R. 673 (Bankr. S.D.N.Y. 2013).
- *In re Jennings*, No. 05-15212, 2006 WL 2826947 (11th Cir. Oct. 4, 2006).
- *In re Balco Equities Ltd., Inc.*, 345 B.R. 87 (Bankr. S.D.N.Y. 2006).
- *In re Congoleum Corp.*, 426 F.3d 675 (3d Cir. 2005).
- *In re eToys, Inc.*, 331 B.R. 176 (Bankr. D. Del. 2005).

Takeaways

- Bankruptcy rules relating to disinterestedness and disclosure are broader than state law conflicts rules.
- Professionals who are required to file Bankruptcy Rule 2014 declarations should take their disclosure obligations very seriously.
- Penalties for non-disclosure can be severe. If in doubt, disclose!

PART II

Specific Conflicts and Disinterestedness Issues

Representing Multiple Debtor Entities

- Very often, multiple legal entities within a single enterprise will file chapter 11 cases. Those separate cases would then be "jointly administered" with each other.
- Technically each entity's bankruptcy case is separate, but the cases are handled jointly. For example, bankruptcy court orders would apply to all of the jointly-administered cases.
- The jointly administered entities typically are all represented by one law firm and one accounting firm.

Representing Multiple Debtor Entities (cont.)

- Jointly administered entities may have significant claims against each other (*i.e.*, "intercompany claims").
- There may be a concern is that the law firm that represents all jointly administered debtor entities will not aggressively pursue one debtor entity's intercompany claim against another.
- This concern is more acute when different third-party creditors have substantial claims against different debtor entities.

Representing Multiple Debtor Entities (cont.)

- This issue could be addressed in various ways:
  - One or more of the entities may hire special counsel to pursue / defend against intercompany claims;
  - Creditors of the entities may be granted derivative standing to pursue intercompany claims;
  - Separate official committees could be appointed for different entities; or
  - A bankruptcy examiner could be appointed to analyze the alleged intercompany claims, and report to the court on the merits of those claims.

Adelphia and Gilbertson Cases

- *In re Adelphia Comm. Corp.*, 336 B.R. 610 (Bankr. S.D.N.Y. 2006), *aff'd* 342 B.R. 122 (S.D.N.Y. 2006) involved debtor entities having large intercompany claims. Court permitted a law firm to represent all of the debtor entities, so long as the firm maintained neutrality regarding intercompany issues.
- In *In re Gilbertson Restaurants, LLC*, 2004 WL 1724878 (Bankr. N.D. Iowa, May 3, 2004), the court permitted a law firm to represent multiple debtor entities that had intercompany claims, because no actual conflict existed at the time of retention.
  - So long as the disputes were not being litigated, any conflict remained only a "potential" conflict, which could be addressed through special conflicts counsel if the conflict became an actual conflict.

Connections With Debtor's Management and Equityholders

- If it is representing an organization (including a closely-held corporation) the law firm needs to ensure that it represents the interests of the organization, rather than the parochial interests of management or equityholders.
- Law firm may have been asked by private equity sponsor (equityholder) to represent its portfolio company as the debtor in a chapter 11 case. That law firm might do other work for sponsor.
- Management and equityholders ideally should have separate counsel that is different than the firm that is representing the organization.

Connections With Debtor's Management and Equityholders (cont.)

- Court may disqualify a proposed professional to the debtor when its connections with the debtor's management or equityholders might cause the professional to be more loyal to management or equityholders than to the debtor.
  - Debtors-in-possession owe fiduciary duties to their creditors and other estate constituents.
  - Directors and officers may have their own agenda and conflicting interests, and may require guidance from the organization's counsel with respect to compliance with fiduciary duties.
  - Equityholders' interests are often adverse to the interests of creditors.

Representation of Both Debtor and Creditor

- 11 U.S.C. § 327(c) provides that a professional will not be disqualified from representing a debtor-in-possession or bankruptcy trustee solely because of the professional's representation of a creditor, absent objection by another creditor or the U.S. Trustee, and absent a finding by the bankruptcy court that an actual conflict of interest exists.
- Disqualification due to a potential conflict of interest is within the bankruptcy court's discretion. If a potential conflict develops into an actual conflict, methods other than disqualification could be available to manage the problem.
- Section 327(c) does not release an attorney from state law ethical requirements.

Representation of Both Debtor and Creditor (cont.)

- In determining whether an actual conflict exists, courts may analyze:
  - whether the actions that the firm might take on behalf of the debtor/trustee client might have a substantial impact on the other firm client;
  - whether there is a risk that the firm's representation of the debtor/trustee client will be limited by its responsibilities to the other firm client;
  - how significant the creditor's role in the bankruptcy case is; and
  - how important the creditor is to the firm (*e.g.*, whether the creditor generates more than 1% or 2% of the firm's revenues).

Representation of Both Debtor and Creditor (cont.)

- The firm's conflict could be resolved by a waiver agreement that is signed by the debtor (or bankruptcy trustee) and by the creditor.
- Upon receiving a waiver from the debtor and the creditor, a firm normally should establish an ethical wall.
- The debtor/trustee could retain special "conflicts" counsel to handle matters that could be directly adverse to the creditor.
- The professional must disclose the existence and terms of any waiver agreement, and of any limitations on scope of the firm's representation of the debtor/trustee.

Imputation of Disqualifying Conflicts

- An entire firm may be subject to disqualification from representing a debtor/trustee if an individual partner or employee at the firm is not "disinterested," even if the firm establishes an ethical wall.
  - *In re Essential Therapeutics*, 295 B.R. 203 (Bankr. D. Del. 2003).
  - *But see In re Sea Island Company*, No. 10–21034, 2010 WL 4386855 (Bankr. S.D. Ga. Oct. 20, 2010) (certain attorneys' lack of disinterestedness is not imputed to the firm, so long as there is an effective ethical wall); *In re Cygnus Oil and Gas Corp.*, 2007 WL 1580111 (Bankr. S.D. Tex. May 29, 2007) (disagreeing with *Essential Therapeutics*).

Unpaid Pre-Petition Fees and Expenses

- A professional who is still owed money by a debtor on account of pre-bankruptcy services is not "disinterested," and thus cannot be retained as a professional to the debtor/trustee.
  - To solve this problem, the professional can waive its unpaid pre-petition fees and expenses.
  - The professional might also be able to solve this problem by selling its claim against the debtor to a third party, so long as the professional no longer retains any financial interest in the debtor's bankruptcy estate.

Professional's Receipt of Preference Payments

- A professional might receive payments from the debtor that are "preferences." The debtor's bankruptcy estate can claw back preferences.
- Preferences are pre-petition payments that:
  - were made to or for the benefit of a creditor;
  - were made for or on account of an antecedent debt;
  - were made on or within 90 days before the bankruptcy filing (or within one year for transfers to "insiders");
  - were made while the debtor was insolvent; and
  - enabled the creditor to receive more than it would have received in a chapter 7 liquidation.

Professional's Receipt of Preference Payments (cont.)

- If a professional receives payments that could plausibly be clawed back as preferences, then the professional may not be "disinterested," and thus cannot be retained as a professional.
- The professional's Bankruptcy Rule 2014 declaration/affidavit should disclose the amount of payments it received in the 90 days before the bankruptcy filing.
- The US Trustee, another party in interest, or the Bankruptcy Court may request additional information about those 90-day payments after the declaration/affidavit is filed.

Professional's Receipt of Preference Payments (cont.)

- The professional may be required to take corrective action as a condition to being retained in the bankruptcy case.
  - This may include paying back the amount that the U.S. Trustee or the bankruptcy court believes is a preference.
  - Alternatively, that amount might be credited against fees and expenses the professional incurs post-petition.
- Bankruptcy court likely cannot "conditionally" approve a professional's retention, and wait for a later determination about whether there was actually a preference.
  - *See, e.g.*, *In re Pillowtex*, 304 F.3d 246 (3d Cir. 2002).

Professional's Receipt of Preference Payments (cont.)

- If a professional represents a debtor before it files bankruptcy, the best practice is for the professional to obtain an advance payment retainer before the bankruptcy filing.
- If the retainer is adequately funded and replenished, and if the professional obtains payment of its fees from the retainer, then the professional's potential preference liability will be diminished.
- The professional should disclose the existence and amount of the retainer in its Bankruptcy Rule 2014 declaration/affidavit.

Professional's Receipt of Preference Payments (cont.)

- A professional may also be able to reduce preference liability by establishing an "ordinary course of business defense."
  - The transfer must have been made in payment of a debt that the debtor incurred in the ordinary course of business or financial affairs, and either
    - The transfer itself was made in the ordinary course of business or financial affairs of the debtor and the creditor, or
    - The transfer was made according to "ordinary business terms." This is typically measured by industry standards.

Payment From Third Parties

- If the debtor lacks sufficient funds to pay its professional, the professional could seek compensation from a third party instead.
- The professional must disclose any payments it receives from third parties, as well as any agreements by third parties to pay its fees and expenses.
- The bankruptcy court could still disqualify the professional if there is an appearance of (or potential for) a conflict.
  - Payments from a third party could tempt the professional to protect the payor's interests, rather than the debtor's interests.

Takeaways

- Be cognizant of potential preference liability with respect to payments you receive from a debtor during the 90 days before bankruptcy.
- Obtain a retainer if at all possible.
- If you are representing the debtor, make sure all of your fees and expenses are paid before the debtor files bankruptcy.
- Obtaining payment from a third party may be permissible, but it may create conflicts issues. Any payments or promises of payment from third parties must be disclosed in the Bankruptcy Rule 2014 declaration.

PART III

Fee Arrangements In Consumer Cases

The Conundrum in Consumer Chapter 7 Cases

- Payment of Chapter 7 counsel's fees must be paid up front, or else the consumer's debt for those fees will be discharged.
- Fees for pre-petition work cannot be paid post-petition.
- The cost of attorney services in no-asset chapter 7 cases is rising.
- Debtor may have insufficient funds to pay up front for their attorneys.

Unbundling of Services

- Unbundling, sometimes referred to as "limited scope representation" or "LSR," provides for the limiting of scope of legal services performed in exchange for paying a lower legal fee.
- Principal benefits: Reduced financial burden on the debtor, fewer *pro se* debtors, fewer failed chapter 13 cases.
- Principal concerns: Debtor might not have legal representation for important parts of the case (e.g., adversary proceedings, discharge challenges, etc.).
- Types of services that may be left out of a "cheap" bundle:
  - Representation of debtor in adversary proceedings;
  - Rule 2004 examinations; and
  - Reaffirmation hearings.

Unbundling: Ethical Issues

- Attorneys must ensure that any limitations on representation are consistent with their responsibilities under the Bankruptcy Code and Rules, as well as under applicable rules of professional conduct.
- Unbundling is only permitted if it is consistent with the duty of competence.
- Unbundling is only permitted if it is reasonable under the circumstances.

Informed Consent

- Unbundling is only permitted if informed consent is given.
- Model Rules of Professional Conduct 1.2(c): A lawyer may limit the scope of representation if the limitation is reasonable under the circumstances and the client gives informed consent.
- The consent should be in writing. Engagement letter language is key.
  - The written consent must demonstrate not only that the client received the necessary information, but that the client understood the import of the limitation on services.
  - An engagement letter that merely states that certain proceedings are excluded from the flat fee is unlikely to suffice.

Consequences of Failure to Satisfy These Obligations

- Reduction or disgorgement of fees.
  - Section 329(b) of the Bankruptcy Code provides that if the compensation received by an attorney "exceeds the reasonable value of any such services, the court may cancel any such agreement, or order the return of any such payment, to the extent excessive."
- Other sanctions.
  - Attorney may be ordered to attend ethics continuing legal education courses, or to provide a copy of the court's sanctions opinion to any future clients.
  - Attorney may be barred from practice before the bankruptcy court in the future.

Takeaways

- Informed consent is required.
- Make sure that limitations of scope are reasonable and are consistent with your ethical duties.
- Be specific in engagement letter language.

Thank you!

Michael J. Riela
Tannenbaum Helpern Syracuse & Hirschtritt LLP
900 Third Avenue
New York, NY 10022
Telephone: 212-508-6700
Email: riela@thsh.com

Thank you!

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