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Disclosures and Conflicts

The USTP's Perspective on Professional Employment

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The U.S. Trustee Program (USTP) plays an important role in bankruptcy by reviewing applications to employ debtor-in-possession (DIP) and official committee professionals.[1] Given the multiplicity of interests in a case — from large to small creditors and from employees to other stakeholders — the Bankruptcy Code and Federal Rules of Bankruptcy Procedure require that professionals seeking to represent the DIP or an official committee disclose their connections to parties in the case and satisfy conflict-of-interest standards.[2]

Although all parties-in-interest have standing to object to the adequacy of disclosures and to a professional's retention because of conflicts, it is usually only the U.S. Trustee who objects. As the "watchdog" of the bankruptcy system, the USTP applies a strict reading of the Code and Rules, and raises conflict and disclosure issues so that courts may adjudicate professional employment applications. In fiscal year 2020, the USTP made 2,476 inquiries and formal objections related to professional employment under §§ 327 and 1103.[3]

This article discusses the USTP's application of the law's disclosure requirements, as well as three settlements between the USTP and several high-profile professional firms arising from their disclosure omissions. It also describes increasingly complex fact patterns and challenging conflict-of-interest issues presented by several retention applications to which the USTP has objected.

1 *See* 28 U.S.C. § 586(a)(3)(E), (I).
2 11 U.S.C. §§ 327(a), 1103; Fed. R. Bankr. P. 2014(a).
3 Congress recently encouraged the USTP "to continue its efforts to ensure a fair and transparent bankruptcy process for stakeholders and for the public" and required the USTP to report its efforts in FY 2020 and FY 2021 to enforce professionals' compliance with the disclosure requirements of Bankruptcy Rule 2014(a). *See* Explanatory Statement for Commerce, Justice, Science, and Related Agencies Appropriations Act 2021, accompanying the Consolidated Appropriations Act 2021 (Pub. L. No. 116-260).

General Legal Principles of Disclosure

Rule 2014 does not define "connection," and § 327(a) of the Code does not define "adverse interest." In *In re Enron Corp*., the court observed that "[t]he purpose of Rule 2014(a) is to provide the court and the [U.S. Trustee] with information to determine whether the professional's employment is in the best interests of the estate."[4] For this reason, the duty of disclosure is not merely critical; it is "sacrosanct."[5] The disclosure required by professionals "goes to the heart of the integrity of the bankruptcy system."[6] Thus, courts universally require broad and complete disclosure of all connections with debtors, creditors and any other party-in-interest.[7]

Professionals must disclose all connections and may not pick and choose the connections to disclose and those to ignore as unimportant or trivial.[8] The reason for broad disclosure is simple: "The decision as to what facts may be relevant should not be left up to the professional, 'whose judgment may be clouded by the benefits of potential employment.'"[9] Moreover, professionals may not place the burden on the court or other parties to "ferret out pertinent information from other sources."[10] Nor can DIPs, committees and their proposed professionals withhold disclosures based on their decision that no conflict exists;[11] that decision is for the court alone, and the court should be provided full disclosure of all connections.

The obligation to disclose connections is an independent obligation, and any failure to disclose

4 No. 02-5638, 2003 WL 223455, at *4 (S.D.N.Y. Feb. 3, 2003).
5 *In re eToys Inc.*, 331 B.R. 176, 189 (Bankr. D. Del. 2005).
6 *In re Universal Bldg. Prods.*, 486 B.R. 650, 663 (Bankr. D. Del. 2010) (quoting *In re B.E.S. Concrete Prods. Inc.*, 93 B.R. 228, 236-38 (Bankr. E.D. Cal. 1988)).
7 *See, e.g., In re Leslie Fay Cos. Inc.*, 175 B.R. 525 (Bankr. S.D.N.Y. 1994).
8 *In re Jore Corp.*, 298 B.R. 703, 726 (Bankr. D. Mont. 2003).
9 *In re Fibermark Inc.*, No. 04-10463, 2006 WL 723495 at *8 (Bankr. D. Vt. March 11, 2006) (quoting *In re Lee*, 94 B.R. 172, 177 (Bankr. C.D. Cal. 1988)).
10 *In re Saturley*, 131 B.R. 509, 517 (Bankr. D. Me. 1991). *See also In re BH & P Inc.*, 949 F.2d 1300, 1317-18 (3d Cir. 1991).

can warrant sanctions, including disqualification or disgorgement, even absent a conflict of interest.[12] The court need not find intent.[13]

USTP Disclosure Principles

The increasingly complex organizational structure of many professional firms makes both the USTP's review of applications to employ and the court's decision on them more challenging. Accordingly, the following general principles guide the USTP's positions in reviewing retention applications.[14]

The USTP seeks to act consistently across districts and regions in this and other legal matters. All USTP personnel who review chapter 11 retention applications are familiar with these principles. Each case will have unique facts to be considered consistent with these principles.

Enforce the Law

The USTP's responsibilities start and stop with a textual reading and strict application of the Code and Rules. Although professionals may adopt internal protocols governing their compliance process, those cannot change substantive law. Nor can internal protocols establish a safe harbor for professionals who do not satisfy the law's strict disclosure and conflict requirements.

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Disclose Connections on the Public Record

Bankruptcy law requires that professionals seeking to be paid from the estate disclose on the public record their connections to a case, even if they have agreed to keep client information (including names) confidential. Professionals can only seek to be excused from public disclosure on the record if they file a properly supported motion to seal the information under § 107 of the Bankruptcy Code for the court to adjudicate. The USTP also has a responsibility to object to a professional's motion to seal the required information if the motion does not satisfy the statute's high bar.

Disclose Affiliate Connections

The professional firm's connections — and that of its affiliates and practice areas — must be disclosed; the requirement to disclose is not confined to professionals working on the bankruptcy engagement. To assess whether there are disabling conflicts, the court, USTP and all parties are entitled to know the connections of the entire organization. For example, if the proposed professional's parent company represents another client interest adverse to the DIP (or the committee's constituency), that information must be disclosed.

Every case is fact-specific, and in rare circumstances, an applicant may be able to establish that the firm is sufficiently separate from affiliated companies or practices by filing a Rule 2014(a) verified statement containing detailed information sufficient to excuse affiliate disclosure. Only the court has the authority to excuse affiliate disclosure.

Disclose Connections Based on Investments

Investments by professionals may create conflicts just as serious as those created by working for clients with adverse interests. A professional's duty to disclose connections extends to investments in entities that are connected with the case. Under the Code and Rules, the disclosure is mandatory, and it is the court that decides whether any connection precludes employment. In recent years, new issues have arisen with the proliferation of professional firms' investment units and their sponsorship of investment funds. For example, firms may provide partners with investment opportunities in clients,[15] or they may have affiliated retirement funds for their employees.

In deciding whether to object to the adequacy of investment disclosures, the USTP will analyze two factors: knowledge and control. If the professional knew or could have known about the investment in an entity that might be involved in the case or in the debtor's industry, that investment should be disclosed. Furthermore, if the professional firm controlled or could have controlled the investment decision in a relevant entity or industry, the investment must be disclosed. Thus, for example, a typical investment in a diversified mutual fund managed by an independent outside advisor need not be disclosed. However, a professional firm that sponsors pooled investments in clients who may be parties-in-interest in the case should disclose those investments.

Three Recent Disclosure Settlements

The USTP has vindicated the importance of disclosures with three high-profile settlements. The first settlement involved a financial advisor that did not disclose the identity of its clients who were parties-in-interest in the case. As a result of discovery and lengthy settlement negotiations, the advisor paid $15 million to the estates of three chapter 11 cases to be distributed to creditors in accordance with the confirmed plans.

The second settlement involved the same advisor's retention application in one of those three cases. The USTP objected, arguing that the firm's disclosures remained insufficient. The firm initially

11 *See In re Granite Partners LP*, 219 B.R. 22, 44 (Bankr. S.D.N.Y. 1998) ("The trustee broke the cardinal principle of Rule 2014(a). He arrogated to himself a disclosure decision that the Court must make.").

12 *In re Universal Bldg. Prods.*, 486 B.R. at 663.

13 *See, e.g., In re Indep. Eng'g Co. Inc.*, 232 B.R. 529, 532 (B.A.P. 1st Cir. 1999).

14 Memorandum from Clifford J. White III, Director, Executive Office for U.S. Trustees, to U.S. Trustees, "Principles to Guide USTP Enforcement of the Duty of Professionals to Disclose Connections to a Bankruptcy Case Under 11 U.S.C. §§ 327 and 1103 and Fed. R. Bankr. P. 2014," (Dec. 4, 2019), *available at* justice.gov/ust/file/generalprinciplesdisclosureconflicts.pdf/download (unless otherwise specified, all links in this article were last visited on June 30, 2021).

15 Angela M. Allen & Richard Levin, "A Review of Potential Conflicts in Private-Equity Representation," XXXVIII *ABI Journal* 1, 54-55, 66, January 2019, *available at* abi.org/abi-journal.

failed to disclose its connections with clients it deemed confidential and the connections of all of its affiliates; it also failed to make adequate disclosures regarding its investments in entities that could create conflicts of interest. The advisor agreed to withdraw the application and to waive payment of its fees and expense reimbursements from the estate.

The third settlement involved three global law firms employed by the DIPs as special counsel to defend claims related to the sale, marketing and distribution of the debtors' products. A major issue in the bankruptcy case was whether and to what extent the DIPs' shareholders shared liability with the DIPs for these claims. Long after the court approved the law firms' retention, the USTP learned that the DIPs and their counsel had previously entered into a joint defense and common interest agreement with the DIPs' shareholders in ongoing tort litigation. The undisclosed joint-defense agreement created obligations for both the debtors and their special litigation counsel toward the shareholders. During the course of the bankruptcy case, the DIPs invoked the agreement to rebuff discovery sought by the official committee of unsecured creditors. After the USTP prepared a motion to disgorge fees based on the firms' failures to disclose, it negotiated a settlement with the firms, which the court approved. Under the settlement, the firms agreed to an aggregate reduction of $1 million in fees and supplemental disclosures regarding the common interest agreement.[16]

Conflicts of Interest and Case Studies

In addition to navigating disclosure issues, the task of identifying whether a professional possesses a disqualifying conflict of interest has become more challenging due to the increasingly complex organizational structure of professional firms, the growth in their size and the broad range of services they offer. Because parties-in-interest rarely object, even though they might have relevant information, it is incumbent upon the USTP to carefully review the professional's disclosures, seek clarification or supplementation where possible, and object as necessary so that the court may adjudicate whether there is a conflict.

The three case studies herein are drawn from actual cases in which the USTP objected to — and, perhaps surprisingly, the court approved — retention. These cases reflect fact patterns that are increasingly common and on which courts have reached differing conclusions. The USTP will continue to strictly read the law and help ensure that courts decide conflict issues only after the professionals provide a sufficient record to support their employment.

Denial of Retention "Too Disruptive"

In one case, the DIP sought to retain a large, sophisticated law firm, which disclosed that it represented the proposed DIP lender and affiliated stalking-horse bidder in unrelated matters. Those parties provided 4 percent of the firm's annual revenue, which was multiple millions of dollars. The firm also represented, in unrelated matters, the bank's collateral agent for the debtor's asset-based lenders, whose pre-petition claim was paid in full as part of a sale motion approved on the case's first day. This bank represented about 1 percent of the firm's annual revenue.

The USTP objected because the professional's significant and deep connections to other parties who were negotiating transactions integral to the case tainted the firm and rendered it not disinterested. In the USTP's view, because the law firm and the debtor filed the retention application knowing those connections, their complaint — that compliance with the Code would be "too disruptive" to the debtor's attempt to fast-track the chapter 11 case — was contrived.

> **The USTP's role is to ensure that the bankruptcy system functions with integrity and efficiency, and this is best accomplished by strict adherence to the Code and Rules, including on matters of disclosure and conflicts of interest.**

Professionals' Conflict Found Not Disqualifying Because They Did Not Act on It

In another case, the DIP sought to retain a major law firm that also represented a private-equity company (PEC), including the PEC's acquisition of 70 percent of the debtor's equity. In the bankruptcy case, the DIP sought quick approval to sell its remaining equity to the PEC, which was also the DIP lender. The law firm disclosed its representation of the PEC in a variety of unrelated matters, which accounted for 1 percent of the law firm's revenues (approximately $21.5 million).

The USTP objected to the proposed retention, arguing that the law firm's continuing representation of the PEC in significant unrelated matters, combined with its prior representation of the PEC in its acquisition of a controlling stake in the debtor, constituted a disqualifying conflict of interest. The court found that 1 percent of firm revenue — despite its high dollar value — was insufficient to influence the firm's independence. The court also independently reviewed the sale terms and determined that they were fair to the DIP. The court concluded that the law firm had adequately represented its client in the sale and had not acted on the alleged conflict by favoring its nondebtor client over the DIP.

However, other courts have held that conflict determinations should be based on the facts in the retention application, not on actions in the case: The court cannot approve a professional's employment using "the benefit of hindsight" and a finding of "no harm, no foul" based on "the quality of the unapproved representation" to establish that the professional did not act on the conflict.[17] Simply put, the Code not only prohibits professionals from *acting* on adverse interests; it prohibits them from *having* them in the first instance.[18]

16 *See In re Molten Metal Tech. Inc.*, 289 B.R. 505, 514 n.20 (Bankr. D. Mass. 2003) (holding that joint defense agreements must always be disclosed and ordering disgorgement of all fees for counsel's failure to disclose).

17 *In re Interwest Bus. Equip. Inc.*, 23 F.3d 311, 317 (10th Cir. 1994). In addition, professionals have a continuing duty to disclose and to remain conflict free.

18 *See In re Big Rivers Elec. Corp.*, 355 F.3d 415, 434 (6th Cir. 2004) (discussing adverse interests of trustees and examiners).

Conflict from Representing Debtors' Parent Cured by "Conflicts Counsel," Even on an Issue Central to the Reorganization

This is another variation on the same theme. A large law firm filed chapter 11 petitions for several subsidiaries of a parent entity that was the firm's long-term and continuing client. Every officer, director and employee of the DIPs was also employed by the parent. Nevertheless, in response to the USTP's objection to the firm's retention, the firm stated that it could represent the DIPs in investigating the parent's role in a questionable initial public offering (IPO) that was controversial among the debtors' creditors and a central issue in the case. The court approved the retention.

Six weeks later, the debtors sought to employ conflicts counsel to represent new independent directors appointed to handle matters involving the parent, including the IPO. The allegedly unconflicted firm now admitted that its conflict prevented it from representing the debtors *vis-à-vis* their parent despite having represented previously that it could. Moreover, conflicts counsel would represent the debtors' interest in pursuing perhaps the most important assets of the estate: claims against the parent. Although the court approved the retention over the USTP's objection, other courts have declined to allow the employment of conflicts counsel where § 327(a) general bankruptcy counsel had a conflict of interest on a matter "central to the bankruptcy."[19]

Conclusion

The USTP's role is to ensure that the bankruptcy system functions with integrity and efficiency, and this is best accomplished by strict adherence to the Code and Rules, including on matters of disclosure and conflicts of interest. When proposed professionals make insufficient disclosures or hold disabling conflicts, the USTP will object and thereby contribute to the continued development of case law in this area. abi

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19 *See In re Project Orange Assocs. LLC*, 431 B.R. 363, 375-76 (Bankr. S.D.N.Y. 2010) (stating that use of conflicts counsel in case was "fig leaf" and that counsel "has not provided the Court with any case law indicating that the use of conflicts counsel warrants retention under section 327(a) where the proposed general bankruptcy counsel has a conflict of interest with a creditor that is central to the debtor's reorganization").