AMERICAN BANKRUPTCY INSTITUTE

2020 Mid-Atlantic Virtual Bankruptcy Workshop

CONCURRENT SESSION

Ethics: How to Get Retained as Debtors' Attorneys

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2020

Fee Application & Compensation Issues

Applicable Bankruptcy Code Sections and Bankruptcy Rules

- The primary Bankruptcy Code Sections are 327, 329, and 330, although other Sections also apply (*e.g.,* 11 U.S.C. § 504).
- The Bankruptcy Rules are generally 2014 and 2016.
- Also, bankruptcy courts often have local rules that govern employment and compensation of attorneys.
- United States Trustee's Guidelines may be applicable.

In re Boy Scouts of America, et al., Case No. 20-10342 (LSS) (Bankr. D. Del. May 29, 2020)

Facts

- Century Indemnity Company and its parent, Chubb Insurance (collectively, "Century") sought to disqualify Sidley Austin ("Sidley") as Debtors' lead counsel based on Sidley's prior representation of Century.
- Sidley represented the Debtors in restructuring matters since approximately early 2019, although it obtained no conflict waiver from either the Debtors or Chubb/Century.
- Sidley withdrew as counsel for Chubb/Century in all matters, the last shortly after the bankruptcy filing.

In re Boy Scouts of America, et al. (cont'd)

Arguments of the Parties

- Century argued that Debtors cannot retain Sidley because Sidley could not satisfy the requirements of Section 327 because it had violated Rule 1.7 of the Model Rules of Professional Responsibility by representing Century against another client, the Debtors.
- Sidley made the following arguments in support of its retention:
  - Rule 1.9, not Rule 1.7, controls because Century is a former client, and Sidley does not need a waiver as representation of Debtors' restructuring is not substantially related to Sidley's previous representation of Century;
  - Sidley does not represent an adverse interest and is disinterested; and
  - Sidley was never adverse to Century while Century was still a client because Haynes & Boone represented Debtors' insurance matters related to restructuring. Debtors argued they would be substantially prejudiced if they had to retain new counsel.

In re Boy Scouts of America, et al. (cont'd)

Court Analysis of Section 327

- Section 327(a) creates a two-part test, a professional (1) may not hold or represent an adverse interest, and (2) must be disinterested. *BSA Op.* at 3.
- The Court followed the Third Circuit's holdings in *In re BH&P*, 949 F.2d 1300 (3d Cir. 1991), *In re Pillowtex, Inc.*, 304 F.3d 246 (3d Cir. 2002), and *In re Marvel Entertainment Group,* 140 F.3d 463 (3d Cir. 1998)
- The two-part test in Section 327 is written in the present tense, and therefore does not apply to prior representations; Sidley's representation of Century had ended and Sidley did not hold an interest adverse to the Debtors.
- Sidley could adequately represent the interest of the estates.

In re Boy Scouts of America, et al. (cont'd)

Was Sidley's work "substantially related" to its prior work for Century?

- Chubb also argued that the Court should disqualify Sidley because "insurance issues in a mass tort case are so pervasive that Sidley's inability to be adverse to Chubb means Sidley's retention cannot be approved."
- The Court also considered whether Sidley's engagement ran afoul of Rule 1.9 of the Rules of Professional Responsibility because it is representing a new client adverse to a former client on a "substantially related" matter.
- Courts generally look at three factors to analyze whether a "substantial relationship" exists:
  - the nature and scope of the prior representation;
  - the nature and scope of the current representation; and
  - the possibility that the former client disclosed confidences to his attorney in the prior representation which could be relevant to the current action and used to the detriment of the former client in the current action.

In re Boy Scouts of America, et al. (cont'd)

Court Rules that Sidley is saved by Conflicts Counsel.

- The Court held that Sidley's previous representation might be substantially related to some aspects of Debtors' bankruptcy cases.
- The Court found no conflict issue because Debtors retained Haynes & Boone as counsel for insurance matters before the bankruptcy filing and Sidley placed an ethical screen between its insurance group and restructuring group so that confidential information could not pass between the two.
- In perhaps the Court's most crucial statement, the judge concluded that, "this decision is consistent with the numerous cases cited to me addressing disqualification of counsel [. . . .] Indeed, I was surprised by the overwhelming body of case law [. . .] in which courts deny disqualification motions in the face of what appear to be obvious conflicts." *BSA Op.* at 13. The Court therefore denied Century's motion to disqualify Sidley as Debtors' lead counsel.
- The Court noted that "retroactive ethical screen may not work for purposes of violations of the Rules of Professional Conduct" leaving open whether Sidley may have violated a Rule of Professional Conduct by simultaneously representing Chubb and the Debtors prior to the screen being established on November 4, 2019.

In re D.C. Diamond Corp.,
Case No. 12-16730-BFK (Bankr. E.D. Va. Oct. 7, 2019)

Facts and Background

- In 2012, the Debtor, a real estate investment company, filed a Chapter 11 and hired Weber Rector ("Weber Rector"), to market and sell its properties.
- In 2015, the Debtor's case converted to Chapter 7 and the trustee employed Weber Rector to continue its work selling the Debtor's properties.
- Weber Rector listed for sale a property on Lucky Hill road (the "Lucky Hill Property").
- Thomas Hugill ("Hugill") learned of Lucky Hill Property and inquired about it from his friend, Chuck Rector who owned a 50% interest in Weber Rector.
- Hugill agreed to buy Lucky Hill Property and additional properties for $1.55 million (the "Parcels").
- In August 2019, the Court held a hearing on approval of the sale of the Parcels where Weber Rector disclosed for the first time that it also represented Hugill in the sale of the Quarry Road property, the proceeds of which would be used to close on the Parcels.
- The Court approved the sale. The Court also issued an order directing Weber Rector to supplement its 2014 disclosures and set a hearing to consider whether Weber Rector was "disinterested" in light of its work for Hugill.

In re D.C. Diamond Corp. (cont'd)

Arguments of the Parties

- Weber Rector argued that it did not act as a dual agent pursuant to Virginia law because it did not represent Hugill in this transaction.
- Objecting creditor argued that it is likely Weber Rector shared confidential information to Hugill during sale negotiations.

Court Analysis and Ruling

- The Court agreed that Weber Rector did not act as a "dual" agent. But, that is not enough.
- All professionals employed by Trustee should be "disinterested," meaning that a broker cannot hold or represent an interest adverse to the bankruptcy estate.
- The Court found that Weber did not meet the disinterested test, therefore, was not entitled to its commission.
- The Court terminated Weber Rector's employment by Trustee.
- The Court stated that it did not find any fraud, however it still lacked confidence in Weber Rector based on its disclosure deficiencies.

NNN 400 Capitol Center LLC v. Wells Fargo Bank, N.A., et al., Adv. Pro. No. 18-50384, (Bankr. D. Del.)

Facts

- Adversary proceeding was initiated in the underlying *In re NNN 400 Capital Center 16, LLC* cases. Defendants took deposition of attorney from Rubin & Rubin, P.A. law firm, 327(e) retained counsel, to determine plaintiffs' assertion of attorney/client privilege over numerous documents. During discovery, it was determined that Rubin & Rubin, P.A. was a fictitious trade name and not a legal entity.
- The Rubins admitted to providing "inaccurate information" in retention application.

In re NNN 400 Capitol Center LLC (cont'd)

Arguments of the Parties

- Defendants sought disqualification of Rubin & Rubin, P.A. from the cases and disgorgement of all fees for numerous violations of Rule 2014 disclosures as well as the failure to the disclose impermissible fee sharing arrangement among the legal entities within the Rubin & Rubin umbrella.
- The following issues were relevant to the Court in support of the Rubins' retention:
  - Florida allows the practice of law under fictitious trade names;
  - The Rubins are not bankruptcy practitioners; and
  - The firms under the Rubin umbrella shared fees based on the number of hours spent and not under a retainer or referral fee arrangement.

In re NNN 400 Capitol Center LLC (cont'd)

Court Analyzes Rule 2014 and Section 504

- Failure to adhere to duty to disclose under Rule 2014 is grounds for disqualification and/disgorgement of fees. However, disqualification for failure to fully disclose is not required in all cases.
- Disqualification here would deprive the Plaintiffs of chosen counsel with the most knowledge and understanding of the facts
- Even with full disclosure, the retention application would not have been denied since Florida allows law firms to operate under fictitious names and the Rubins are not bankruptcy practitioners
- The firms operating under Rubin & Rubin umbrella are for all intents and purposes a partnership, with fee sharing among its partners, not impermissible fee sharing arrangement
- The Lawyers were directed to update disclosures but were barred from collecting fees to comply with disclosure requirements, had to disgorge prior fees relating to disclosures, and had to pay attorneys' fees incurred by Defendants' attorneys

In re NNN 400 Capitol Center LLC (cont'd)

Rubin & Rubin's Woes Do Not End

- US Trustee moves to revoke and terminate Rubin & Rubin and deny all fees and expenses:
  - Failed to disclose pre-petition fee sharing agreement with loan broker and filed affidavit that no such agreement exists
  - Failed to seek Court approval of loan broker's retention
  - Failed to disclose impermissible post-petition fee-sharing arrangement with loan broker
- The Court has granted non-client litigants standing to enforce technical violations of conflict of interest rules because the asserted allegations affect "the fair and efficient administration of justice"

In re Lewis Road, LLC, 2011 WL 6140747 (Bankr. E.D. Va. Dec. 29, 2011)

Facts and Background

- The Debtor filed a Chapter 11 petition in February 2009.
- The Debtor's only assets consisted of two parcels of land (the "Parcels") with lenders secured by the Parcels, EVB and Talley.
- In December 2009, Debtor retained Ayers & Stolte as counsel (the "Firm").
- The Firm disclosed in its application that it had a connection with "a creditor" and that "[t]his potential conflict of interest has been waived . . ." but never filed a verified statement as required by Bankruptcy Rule 2014.
- The Firm "did not provide with its Application any information concerning the identity, nature, or scope of its 'connections with a creditor' nor did it provide any information concerning the waiver of the 'potential conflict.'"

In re Lewis Road, LLC

Facts and Background (cont'd)

- In December 2010, a dispute arose between the Debtor and its tenant on the Parcels over return of the property to the Debtor following expiration of the lease.
- To resolve the dispute, the tenant agreed to transfer an adjacent lot to the Debtor and to pay the Debtor $350,000, of which $74,000 was to go to Talley for its attorneys' fees and $25,000 to the Debtor for maintenance of the Parcels (the "Settlement").
- The Debtor sought and obtained approval of the Settlement.
- After approval of the Settlement, the Debtor sought approval of an offer to purchase the Parcels (the "Proposed Sale").
- At the hearing to approve the potential sale, the UST informed the Court that it had recently learned that the Firm had been representing both the Debtor and Talley during the bankruptcy case including during the negotiation of the Settlement.

In re Lewis Road, LLC (cont'd)

Facts and Background (cont'd)

- In response, Alexander Ayers of the Firm explained that his father, Charles Ayers, had not been retained to represent Talley when the Firm filed its application for employment and that he believed it was not necessary to disclose the representation because "everyone was working together to achieve a positive resolution of this matter."
- Further, counsel for EVB informed the court that the Firm claimed to have received an opinion from the Virginia State Bar permitting the joint representation of the parties with their consent. At the end of the hearing, the Court approved the Proposed Sale.
- The Court also issued an order to the Debtor to show cause why a Chapter 11 Trustee should not be appointed and set an evidentiary hearing on the matter (the "Show Cause Hearing").
- Prior to the Show Cause Hearing, the Firm filed a letter with the Court attempting to justify its failure to disclose its dual representation during the bankruptcy case on three grounds: 1) the Court knew of the dual representation because both lawyers at the Firm had appeared at a prior hearing each representing different parties, 2) the Firm had disclosed connections to a "creditor" in the Application, and 3) the Firm had obtained a waiver from each client.

In re Lewis Road, LLC (cont'd)

Facts and Background (cont'd)

- The court appointed a Chapter 11 Trustee (the "Trustee") and, after appointment of the Trustee, the Firm filed an application for compensation in representing the Debtor in the 9019 settlement.
- The Trustee and the U.S. Trustee objected and filed a Rule 60(b) motion seeking relief to prevent paying the Firm compensation for representing Debtor and the 9019 settlement money owed to Talley for its attorneys' fees.
- At the hearing, the Court learned for the first time, that Charles Ayers held a 1/3 participation interest in Talley in the debt owed by Debtor to Talley.
- The U.S. Trustee also provided evidence that Talley never received the $74,000 under the Settlement Agreement because it had been paid to the Firm without Talley's knowledge or consent, and that the Firm also retained the $25,000 that was supposed to go to the Debtor for maintenance of the Parcels.
- Finally, the U.S. Trustee also questioned whether the Firm's time entries had been reconstructed to justify earlier payments.

In re Lewis Road, LLC

- In its analysis, the Court considered the Trustee's request for relief under Rule 60(b)
- Rule 60(b)(3) "permits a court to relieve a party from final judgment, order, or proceeding for fraud, misrepresentation, or misconduct by an opposing party."
- To win on this ground, the movant must have (1) a meritorious defense, (2) been prevented from fully presenting defense before entry of judgment, and (3) been so prevented because of adverse party's fraud, misrepresentation, or misconduct. The Trustee satisfied all three.
- Meritorious Defense - the Court held that the Firm had an adverse interest to Debtor by concurrently representing Talley, a secured creditor of the Debtor with a lien in property of the estate, and
- Prevented from Being Considered before Judgment - failed to properly disclose its connections with Talley, which would have informed the Court of the conflict much earlier.
- Prevented from Being Discovered because of Misrepresentation - The Firm failed to submit a verified statement of its connections, which is a *per se* violation of Rule 2014. The Firm's application acknowledging its connection to a creditor was also too vague and failed to fully explicate its connections.
- The Firm's conflict waiver not helpful - the conflict could not be waived under Virginia Rule of Professional Responsibility 1.7. Even if the waiver was effective, Ayers still had to meet the Section 327 requirements for employment.

In re Lewis Road, LLC

Court Analysis and Ruling

- The Court also granted the Trustee relief based on the catch-all provision in Rule 60(b)(6) used, "if such action is appropriate to accomplish justice."
- The Court found that the Firm received the $74,000 payment for attorneys' fees before the entry of the 9019 Order, and therefore was not authorized.
- In addition, the Court inferred that the Firm likely fabricated its billing records to justify the payment.
- Finally, the Court found that the Firm violated the 9019 Order by taking the $25,000 meant for Debtor to hold for maintenance. The Court held that relief under Rules 60(b)(3) and 60(b)(6) shall be granted and that Ayers must disgorge the $74,000 and the $25,000 to the Trustee.

BEST PRACTICES

A. Applicable Bankruptcy Code Sections and Bankruptcy Rules

Employment and payment of bankruptcy professionals is governed by various provisions of the Bankruptcy Code and Bankruptcy Rules. The primary Bankruptcy Code Sections are 327, 329, and 330, although other Sections also apply (*e.g.,* 11 U.S.C. § 504). The Bankruptcy Rules are generally 2014 and 2016. Also, bankruptcy courts often have local rules that govern employment and compensation of attorneys.

The process for employment and payment differs slightly depending on the chapter of the Code under which the case is filed. For example, Bankruptcy Code Section 327 applies to employment of estate professionals (*e.g.*, chapter 11 debtor's counsel, chapter 7 trustee's counsel) but does not apply to debtor's counsel in a chapter 7 case. However, all attorneys must comply with Bankruptcy Rule 2016(b), which requires disclosure of compensation by attorneys within fourteen (14) days of the case being filed. Furthermore, various jurisdictions have adopted local rules containing district specific requirements that govern employment of professionals. *See, e.g.*, Rule 2016-1, Local Rules for the District of Delaware (requiring a professional to disclose all compensation received within one year before the petition date for services rendered in contemplation of or in connection with the case and the source of such compensation; Rule 2015-1 of the Local Rules for the District of Maryland (governs compensation by debtor in chapter 11); Rule 2014-1(b)(1), Local Rules for the Southern District of Texas (requiring applications to be employ to be filed within 30 days if the professional seeks *nunc pro tunc* employment). Chapter 13 lawyers need to be familiar with the "no look" fee rules that are adopted in the various jurisdictions. *See, e.g.*, Standing Order No. 17-2 (Bankr. E.D. Va.); App'x F to the Local Rules for the U.S. Bankruptcy Court for the District of Maryland entitled "Chapter 13 Debtor's Counsel Responsibilities and Fees" (setting forth various fee arrangements that are pre-approved by the Court). Finally, counsel must be mindful of any United States Trustee's Guidelines that may be applicable. *See, e.g.*, "Guidelines Reviewing Applications for Compensation filed under 11 U.S.C. § 330 in (1) Larger Chapter 11 Cases by those Seeking Compensation Who are not Attorneys, (2) all Chapter 11 Cases Below the Larger Case Thresholds, and (3) cases under other chapters of the Bankruptcy Code" and "Guidelines for Reviewing Applications for Compensation and Reimbursement of Expenses Filed under 11 U.S.C. § 330 for Attorneys in Larger Chapter 11 Cases" which can be found at the following website: www.justice.gov/ust/fee-guidelines.

B. *In re Boy Scouts of America, et al.*, Case No. 20-10342 (LSS) (Bankr. D. Del. May 29, 2020) (the "BSA Op.")

In this Chapter 11 case, Century Indemnity Company ("Century"), an insurer of the Debtors, filed a motion to disqualify Sidley Austin ("Sidley") as Debtors' lead restructuring counsel based on Sidley's prior representation of Century. After briefing and an evidentiary hearing, the Court denied Century's motion to disqualify.

In 2015, Chubb, Century's parent company, retained Sidley's insurance group for reinsurance matters. In 2018 and 2019, Century hired Sidley for reinsurance matters relating to Debtors. In January 2020, Sidley informed Century and Chubb of its intention to withdraw from

all representations and stated the last matter withdrawal will occur in February 20 or February 24. In February 18, 2020, Debtors filed their bankruptcy petition and retained Sidley as counsel.[1]

Century argued that Debtors cannot retain Sidley because Sidley could not satisfy the requirements of Section 327 because it had violated Rule 1.7 of the Model Rules of Professional Responsibility by representing Century against another client, the Debtors. *BSA Op.* at 2. Sidley argued made the following arguments in support of its retention:

(1) Rule 1.9 is the controlling ethics, not Rule 1.7, as Century is a former client, and Sidley does not need a waiver as representation of Debtors' restructuring is not substantially related to Sidley's previous representation of Century;

(2) it does not represent an adverse interest and is disinterested; and

(3) it was never adverse to Century while Century was still a client because Haynes & Boone represented Debtors' insurance matters related to restructuring. Debtors argued they would be substantially prejudiced if they had to retain new counsel.

BSA Op. at 3.

In its analysis, the Court found that Section 327(a) creates a two-part test, a professional (1) may not hold or represent an adverse interest, and (2) must be disinterested. *BSA Op.* at 3. The Court followed the Third Circuit's holdings in *In re BH&P*, 949 F.2d 1300 (3d Cir. 1991), *In re Pillowtex*, *Inc.*, 304 F.3d 246 (3d Cir. 2002), and *In re Marvel Entertainment Group,* 140 F.3d 463 (3d Cir. 1998) that Section 327 does not vindicate the rights of non-debtors. The Court noted that the two-part test in Section 327 is written in the present tense, and therefore does not apply to prior representations. As Sidley's representation of Century had ended, Sidley did not hold an interest adverse to the Debtors. Furthermore, the Court also found that Sidley could adequately represent the interest of the estates. The Court found that Century is not a current client and therefore Sidley satisfied the two-part test of Section 327. *BSA Op.* at 5

Even though the Court found that Sidley met the retention requirements of Section 327, Chubb also argued that the Court should disqualify Sidley because "insurance issues in a mass tort case are so pervasive that Sidley's inability to adverse to Chubb means Sidley's retention cannot be approved." *BSA Op.* at 5-6. Thus, the Court also considered whether Sidley's engagement ran afoul of either Rule 1.7 or 1.9 of the Rules of Professional Responsibility. As discussed above, Rule 1.7 protects current clients and is not applicable. Rule 1.9, however, applies to former clients and prevents a lawyer from representing a new client adverse to a former client on a "substantially related" matter. Courts generally look at three factors to analyze whether a "substantial relationship" exists:

(1) the nature and scope of the prior representation;

(2) the nature and scope of the current representation; and

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[1] Sidley represented the Debtors in restructuring matters since approximately early 2019, although it obtained no conflict waiver from either the Debtors or Chubb/Century.

(3) the possibility that the former client disclosed confidences to his attorney in the prior representation which could be relevant to the current action and used to the detriment of the former client in the current action.

BSA Op. at 8. After reviewing the evidence, the Court held that Sidley's previous representation might be substantially related to some aspects of Debtors' bankruptcy cases. However, the Court found no conflict issue because Debtors retained Haynes & Boone as counsel for insurance matters before the bankruptcy filing and Sidley placed an ethical screen between its insurance group and restructuring group so that confidential information could not pass between the two.[2]

In perhaps the Court's most crucial statement, the judge concluded that, "this decision is consistent with the numerous cases cited to me addressing disqualification of counsel [. . . .] Indeed, I was surprised by the overwhelming body of case law [. . .] in which courts deny disqualification motions in the face of what appear to be obvious conflicts." *BSA Op.* at 13. The Court therefore denied Century's motion to disqualify Sidley as Debtors' lead counsel.

C. *In re D.C. Diamond Corp.,* Case No. 12-16730-BFK (Bankr. E.D. Va. Oct. 7, 2019) ("D.C. Diamond Op.")

In 2012, the Debtor, a real estate investment company, filed a Chapter 11 bankruptcy. *D.C. Diamond Op.* at 2. In 2013, Debtor hired Weber Rector ("Weber Rector"), a commercial real estate brokerage firm, to market and sell its properties. In 2015, the Debtor's case converted to Chapter 7. *D.C. Diamond Op.* at 3. The Chapter 7 Trustee employed Weber Rector to continue its work selling the Debtor's properties.

In February 2016, Weber Rector listed for sale a property on Lucky Hill road (the "Lucky Hill Property"). Thomas Hugill ("Hugill") learned of Lucky Hill Property and inquired about it from his friend, Chuck Rector who owned a 50% interest in Weber Rector. Hugill offered to buy the Lucky Hill Property and eventually settled with the Trustee to purchase it and additional properties for $1.55 million (the "Parcels"). *D.C. Diamond Op.* at 7.

In August 2019, the Court held a hearing on approval of the sale of the Parcelsand an objection filed by a creditor. *Id.* At the hearing, Weber Rector disclosed for the first time that, in addition to representing the Trustee, it also represented Hugill in the sale of the Quarry Road property, the proceeds of which would be used to acquire the Parcels in a Section 1031 exchange. The Court approved the sale. The Court also issued an order directing Weber Rector to supplement its 2014 disclosures and set a hearing to consider whether Weber Rector was "disinterested" in light of its work for Hugill. *Id.*

Weber Rector argued that it did not act as a dual agent pursuant to Virginia law because it did not represent Hugill in this transaction. Milic argued that it is likely Weber Rector shared

[2] The Court noted that "retroactive ethical screen may not work for purposes of violations of the Rules of Professional Conduct" leaving open whether Sidley may have violated a Rule of Professional Conduct by simultaneously representing Chubb and the Debtors prior to the screen being established on November 4, 2019. BSA Opinion at 11-12

confidential information to Hugill during sale negotiations. *D.C. Diamond Op.* at 9. The Court agreed that Weber Rector did not act as a "dual" agent. *Id.*

The Court noted that Section 327(a) "requires more" in that all professionals employed by Trustee should be "disinterested," meaning that a broker cannot hold or represent an interest adverse to the bankruptcy estate. Weber Rector's representation of Hugill on a sale of the Quarry Road property put it adverse to the estate because Hugill could refuse to buy the Parcels if the Quarry Road sale didn't close. *D.C. Diamond Op.* at 9-10. Furthermore, Bankruptcy Rule 2014(a) required Weber Rector to disclose all connections with the debtor, creditors, and any other parties-of-interest, which it failed to do. While the Court agreed with Weber that it did not act as a dual agent, that alone did not mean that Weber Rector met the "disinterested" standard. The Court, therefore found that Weber did not meet the disinterested test, therefore, was not entitled to its commission. *D.C. Diamond Op.* at 9-10. The Court went further, terminating Weber Rector's employment by Trustee. The Court stated that it did not find any fraud, however it still lacked confidence in Weber Rector based on its disclosure deficiencies. *D.C. Diamond Op.* at 10.

D. *In re Lewis Road, LLC*, 2011 WL 6140747 (Bankr. E.D. Va. Dec. 29, 2011) ("*Lewis Road* Op.")

The Debtor filed a Chapter 11 petition in February 2009. At the time of filing, the Debtor's only assets consisted of two parcels of land (the "Parcels"). EVB and Talley had liens against the Parcels. *Lewis Road* Op., * 1.

In December 2009, Debtor retained Ayers & Stolte as counsel (the "Firm"). *Lewis Road* Op., * 1. In its application to be employed, the Firm disclosed that it had a connection with a with "a creditor" and that "[t]his potential conflict of interest has been waived . . . ." *Id.* The Firm never filed a verified statement as required by Bankruptcy Rule 2004. Moreover, the Firm "did not provide with its Application any information concerning the identity, nature, or scope of its 'connections with a creditor' nor did it provide any information concerning the waiver of the 'potential conflict.'" *Lewis Road* Op., * 2.

In December 2010, a dispute arose between the Debtor and its tenant on the Parcels over return of the property to the Debtors following expiration of the lease. *Id.* To resolve the dispute, the tenant agreed to transfer an adjacent lot to the Debtor and to pay the Debtor $350,000, of which $74,000 was to go to Talley for its attorneys' fees and $25,000 to the Debtor for maintenance (the "Settlement"). *Id.* The Debtor sought and obtained approval of the Settlement under Bankruptcy Rule 9019. *Id.*

After approval of the Settlement, the Debtor sought approval of an offer to purchase the Parcels (the "Proposed Sale"). *Id.* At the hearing to approve the potential sale, the UST informed the Court that it had recently learned that the Firm had been representing both the Debtor and Talley during the bankruptcy case including during the negotiation of the Settlement. *Id.*

In response, Alexander Ayers explained that his father, Charles Ayers, had not been retained to represent Talley when the Firm filed its application for employment and that he believed it was not necessary to disclose the representation because "everyone was working together to achieve a positive resolution of this matter." *Lewis Road* Op., * 3. Further, counsel for EVB informed the court that the Firm claimed to have received an opinion from the Virginia State

Bar permitting the joint representation of the parties with their consent. *Id.* At the end of the hearing, the Court approved the Proposed Sale. The Court also issued an order to the Debtor to show cause why a Chapter 11 Trustee should not be appointed and set an evidentiary hearing on the matter (the "Show Cause Hearing"). *Id.*

Prior to the Show Cause Hearing, the Firm filed a letter with the Court attempting to justify its failure to disclose its dual representation during the bankruptcy case on three grounds: 1) the Court knew of the dual representation because both lawyers at the Firm had appeared at a prior hearing each representing different parties, 2) the Firm had disclosed connections to a "creditor" in the Application, and 3) the Firm had obtained a waiver from each client. *Lewis Road* Op., * 3.The Firm did not present any evidence at the Show Cause Hearing and the court appointed a Chapter 11 Trustee (the "Trustee"). *Id.*

After appointment of the Trustee, the Firm filed an application for compensation in representing the Debtor in the 9019 settlement. *Id.* The Trustee and the U.S. Trustee objected and filed a Rule 60(b) motion seeking relief to prevent paying the Firm compensation for representing Debtor and the 9019 settlement money owed to Talley for its attorneys' fees. *Id.* At the hearing, the Court learned for the first time, that Charles Ayers held a 1/3 participation interest in Talley in the debt owed by Debtor to Talley. *Lewis Road* Op., * 4. The U.S. Trustee also provided evidence that Talley never received the $74,000 under the Settlement Agreement because it had been paid to the Firm without Talley's knowledge or consent, and that the Firm also retained the $25,000 that was supposed to go to the Debtor for maintenance of the Parcels. *Id.* Finally, the U.S. Trustee also questioned whether the Firm's time entries had been reconstructed to justify earlier payments.

In its analysis, the Court found that Trustee was entitled to its Rule 60(b) relief because Ayers violated § 327 of the Bankruptcy Code and was thus not entitled to compensation. *Lewis Road* Op., * 5. Rule 60(b)(3) relief is an exception to the general policy of favoring final judgments and the movant must meet the following four threshold requirements by demonstrating, (1) timeliness of the motion, (2) lack of unfair prejudice to opposing party, (3) a meritorious defense, and (4) exceptional circumstances. *Lewis Road* Op., * 7. If the threshold requirements are met, movant must satisfy one of the six specific grounds in Rule 60(b) for relief to be granted. The one relied on by Trustee is Rule 60(b)(3) which, "permits a court to relieve a party from final judgment, order, or proceeding for fraud, misrepresentation, or misconduct by an opposing party." To win on this ground, the movant must have (1) a meritorious defense, (2) been prevented from fully presenting defense before entry of judgment, and (3) been so prevented because of adverse party's fraud, misrepresentation, or misconduct. *Id.*.

In finding that Trustee had a meritorious defense, the Court held that the Firm had an adverse interest to Debtor by concurrently representing Talley, a secured creditor of the Debtor with a lien in property of the estate. *Id.* The Firm failed to properly disclose its connections with Talley, which would have informed the Court of the conflict much earlier. While the Court acknowledged that a professional under §327 is not disqualified solely because of its connections with a creditor, the Trustee timely objected and the Court found an actual conflict existed. *Lewis Road* Op., * 8. The Court found the Firm's failure to properly disclose its connections to Talley prevented that issue from being considered by the Court before the 9019 Order. The Firm failed to submit a verified statement of its connections, which is a *per se* violation of Rule 2014. The Firm's application acknowledging its connection to a creditor was also too vague and failed to fully

explicate its connections. *Lewis Road* Op., * 9. Ayers' purported conflict waiver did not save it either because the conflict could not be waived under the Virginia Rules of Professional Responsibility. Va. R. of Prof. Conduct 1.7. *Lewis Road* Op., * 10. And, the Court further held, even if the waiver was effective, Ayers still had to meet the Section 327 requirements for employment. *Id.*

The Court also granted the Trustee relief based on the catch-all provision in Rule 60(b)(6) used, "if such action is appropriate to accomplish justice." *Lewis Road* Op., * 13. The Court found that the Firm received the $74,000 payment for attorneys' fees before the entry of the 9019 Order, and therefore was not authorized. *Lewis Road* Op., * 14. In addition, the Court inferred that the Firm likely fabricated its billing records to justify the payment. Finally, the Court found that Ayers violated the 9019 Order by taking the $25,000 meant for Debtor to hold for maintenance. The Court held that relief under Rules 60(b)(3) and 60(b)(6) shall be granted and that Ayers must disgorge the $74,000 and the $25,000 to the Trustee.

E. NNN 400 Capitol Center LLC v. Wells Fargo Bank, N.A., et al., Adv. Pro. No. 18-50384, (Bankr. D. Del.)

In *NNN Capitol Center LLC v. Wells Fargo Bank, N.A., et al,* Adv. Pro. No. 18-50384, Dorsey, J. (August 9, 2019), the Defendants took the deposition of one of the Debtor attorneys in connection with his work for the Debtor in an effort to determine the legitimacy of Plaintiffs' assertion of attorney-client privilege over numerous documents and testimony. During his deposition, Debtors' attorney testified that Debtor's Florida law firm was not an actual legal entity, but, rather, a "fictitious trade name". Concerned about whether proper disclosure was made in connection with the Debtors' attorneys' retention, the Court requested briefing on what impact this information had on the retention of Debtors' attorneys.

Defendants sought an order disqualifying Debtors' attorneys from the case and disgorgement of all fees paid to date.

The State of Florida's "Fictitious Name" statute provides that a person may engage in business under a fictitious name if the name is properly registered with the Florida Division of Corporations. The statute further provides that a fictitious name can include the term "P.A." if the person or business for which the name is registered is organized as a professional corporation.

The Court had entered an order approving the retention of the Debtors' Florida law firm on March 1, 2017. The retention application and verified statement made no mention that the law firm was a fictitious trade name, nor did it identify any of the actual firms that operated under the fictitious name umbrella. The application also failed to disclose that two other attorneys, who would be working with the Debtor's retained law firm.

The Court held that Bankruptcy Rule 2014 is the mechanism by which the Court enforces the provisions of Bankruptcy Code section 327. Rule 2014(a) requires, in relevant part, that: The application shall state the specific facts showing the necessity for the employment, name of the person to be employed, the reasons for the selection, the professional services to be rendered, any

proposed arrangement for compensation, and, 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. Fed. R. Bankr. P.2014(a).

The Court noted that the disclosure mandated under Rule 2014 "goes to the heart of the integrity of the bankruptcy system". *In re B.E.S, Concrete Prods., Inc.*,93 B.R. 228, 236 (Bankr. E.D. Cal. I 988). The Court held that disclosure under Rule 2014 is of the upmost importance, as it allows the bankruptcy court to make an informed decision on whether employment of the particular professional is in the best interest of the estate. *In re eToys, Inc.*,33l B.R. 176, 189 (Bankr. D. Del. 2005) ("the duty to disclose under Bankruptcy Rule 2014 is considered sacrosanct because the complete and candid disclosure by an attomey seeking employment is indispensable to the court's discharge of its duty to assure the attorney's eligibility for employment"). Indeed, the professional must disclose all potential and actual connections, "not pick and choose which to disclose and which to ignore." *In re Universal Bldg. Products*, 486 B.R. 650, 663 (Bankr. D. Del. 2010).

Defendants' attorneys conceded that they provided the court with "inaccurate information" in their application for retention. The Court found that Debtors' attorneys should have clearly identified that the law firm sought to be retained was a fictitious trade name, it should have identified the different attorneys and law firms operating and associating under the fictitious trade name.

The Court held that duty to disclose under Rule 2014 is so important that the failure to disclose is an independent ground for disqualification and/or disgorgement of fees. *In re Universal Bldg. Products*, 486 B.R. at 663. ("[f]ailure to disclose connections itself is enough to warrant disqualification of counsel from employment."); *In re Filene's Basement, Inc*. 239 B.R. 845 (Bankr. D. Mass. 1999) (false Rule 2014 disclosure alone justified disqualification). However, the Court noted that disqualification for failure to fully disclose under Rule 2014 is not required in all cases. The bankruptcy court's power to disqualify a professional derives from its inherent authority to supervise the professionals in proceedings before it, and the exercise of such authority is within the sound discretion of the bankruptcy court. *U.S. v. Miller*,624 F.2d I198, 1201 (3rd Cir. 1980); *Accord In re Leslie Fay Companies, Inc*. 175 B.R. 525,663 (Bankr. S.D.N.Y. 1994) (declining to disqualify counsel but imposing economic sanctions for failure to adequately disclose).

Therefore the Court held that although it was clear that the disclosures filed in the retention of Debtors' attorneys were defective, the Court did not disqualify counsel or require them to disgorge their fees. The Court said disqualification would deprive the Plaintiff Debtors of their chosen counsel, who have the most knowledge and understanding of the facts surrounding the proceeding. Moreover, even if all of the information had been properly disclosed, the Court did not believe that the application for employment would have been denied. The Defendants' attorneys had been practicing in the State of Florida under the fictitious trade name for nearly 30 years. In Florida, it was legal to operate a law firm under a fictitious name in Florida. It was also not lost on the Court that these Debtors' attorneys were not bankruptcy practitioners-and thus not accustomed to the

stringent disclosure requirements mandated by the Bankruptcy Rules. The Court determined that the attorneys likely had no intent to deceive the court when they failed to adequately disclose the attorneys and entities that practice under the umbrella of the fictitious trade name.

Defendants also asserted that because the officially retained Debtors' attorneys were a fictitious entity made up of separate law firms, the payment of fees to that fictitious entity constituted impermissible fee sharing. Section 504 of the Bankruptcy Code provides, in relevant part, that a professional receiving compensation from estate assets shall not share or agree to share that compensation with another person, unless that person is a member, partner, or regular associate of the professional's firm. 11 U.S.C. $ 504(a)-(b). Debtors' attorneys argued that certain of the attorneys merely acted in an "of counsel" relationship and should be considered as employees of the firm for purposes of sharing compensation under section 504.

In Lemonedes v. Balaber-Strauss (In re Coin Phones, lnc.),226 B.R. 131,132 (S.D.N.Y. 1998), an attorney who was retained by a law firm to work on a case-by-case basis, each instance effectuated by a separate agreement. *In In re Worldwide Direct Inc*.,316 B.R. 637,648 (Bankr. D. Del. 2004), a law firm hiring temporary associate attorney employees through a staffing agency were held to be regular associates because the law firm directly supervised the attorneys and provided everything necessary to do the work. Though informative, the Court held that neither of these cases were directly on point.

The Court ultimately determined that the primary attorneys and the two primary law firms operating under the fictitious name were two distinct legal entities, but they shared the same office space and as a matter of longstanding practice, regularly represented themselves to the public one entity, which was the name displayed outside of the office building. Furthermore, the record established that the fees shared on every case were based on the hours each put into the case, as opposed to a retainer or a referral fee. The Court concluded that the two firms operating under the fictitious name were for all intents and purposes a partnership, with fee sharing among its partners. Thus, the Court found no impermissible fee sharing arrangement.

However, the negligent failure to disclose did not relieve the Debtors' attorneys from the consequences of failing to make a fulsome and accurate disclosure. *In re Hathaway Ranch Partnership*, 116 B.R. 208,219-220 (Bankr. C.D. Cal. 1990); *see also In re B.E.S Concrete Products, Inc*., 93 B.R. at 237 ("Negligent omissions do not vitiate the failure to disclose."). While the Court was not willing to disqualify counsel, the Court exercised its inherent authority to supervise the professionals appearing before it and imposed sanctions. The attorneys were required to update their disclosures to provide full and accurate information. No fees would be allowed for updating the disclosures, and any fees collected by Debtors' attorneys related to the initial disclosures were to be disgorged. The attorneys were to provide the Court with a sworn statement outlining the amount to be refunded to the Debtors within five (5) business days. Moreover, the Debtors' attorneys were required to pay the Defendants' attorneys' fees and costs in bringing the Motion.