AMERICAN BANKRUPTCY INSTITUTE

Mid-Atlantic Bankruptcy Workshop

Rule 2014: Beyond "Disclose, Disclose, Disclose"

Ferve E. Khan, Moderator
BakerHostetler LLP | New York

Scott F. Gautier
Faegre Drinker Biddle & Reath LLP | Los Angeles

Jaclyn C. Marasco
Faegre Drinker Biddle & Reath LLP | Wilmington, Del.

Hon. Jerrold N. Poslusny, Jr.
U.S. Bankruptcy Court (D. N.J.) | Camden

Andrew R. Vara
U.S. Trustee's Office | Cleveland

2024

MID-ATLANTIC
Bankruptcy Workshop

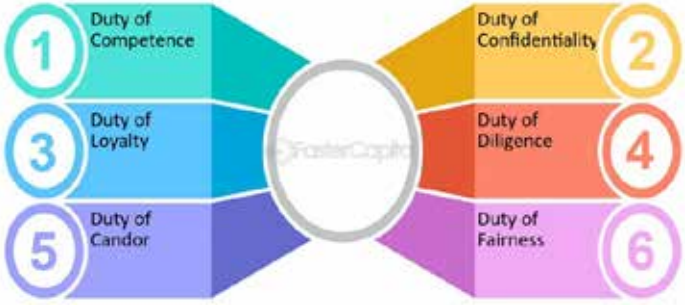
OVERVIEW

- State ethics rules do not always fit the realities of bankruptcy practice. Numerous parties with shifting allegiances; different from two-party adversarial matter.
- Courts have recognized that the model rules promulgated by the ABA may be "ill-adapted" to bankruptcy proceedings, where "administrative matters rather than litigation may be the focus of an attorney's work." *In re Nguyen*, 447 B.R. 268, 277 (9th Cir. B.A.P. 2011).
- Bankruptcy Code and Rules impose mandatory and practical obligations to reflect ethical considerations:
  - Section 327: proposed counsel for the trustee should have no "interest adverse to the estate" and should be "disinterested persons"
  - "[I]n the bankruptcy context we are not constrained simply by the Code of Professional Responsibility but by the Bankruptcy Code itself." *In re The Leslie Fay Cos., Inc.*, 175 B.R. 525, 538 (Bankr. S.D.N.Y. 1994)

MID-ATLANTIC Bankruptcy Workshop

LEGAL ETHICS

The General Provisions of Legal Ethics



MID-ATLANTIC Bankruptcy Workshop

ETHICS UPHOLD THE INSTITUTION

To protect the institution of law, lawyers must ensure that they do not engage in any conduct that undermines the administration of justice, their professional reputation, the reputation of the legal profession or the public's confidence in the legal system.

ETHICS VIOLATIONS

Erosion of the legal system and institution.

Court/Bar Imposed consequences can include:
1. Professional Sanctions
2. Civil Liability
3. Criminal Liability
4. Reputation Damage
5. Loss of Privileges

QUESTION

TRUE OR FALSE

A violation of the Rules of Professional Conduct mandates disqualification of the violating professional.

ANSWER

FALSE

"Section 327 and the Rules of Professional Conduct impose independent obligations.… Because the power to disqualify stems from a court's authority to supervise the attorneys appearing before it, a decision about whether to use that power is discretionary and never is automatic. Even when an ethical conflict exists (or is assumed to exist), a court may conclude based on the facts before it that disqualification is not an appropriate remedy."

In re Boy Scouts of Am., 35 F.4th 149, 158-160 (3d Cir. 2022)
(internal quotation marks and citations omitted) (emphasis added)

DISCLOSURE OBLIGATIONS

- Sections 327 and 1103 of the Bankruptcy Code set forth specific standards that proposed professionals must meet to be retained as an estate or committee professional.
- They require the professional to meet certain standards of independence from parties other than their client.
- Fed. R. Bankr. P. 2014 requires a proposed professional to disclose connections that may raise an actual or potential conflict of interest with the client.

DISCLOSURE OBLIGATIONS

Bankruptcy Rule 2014: Employment of Professional Persons

(a) Application for and Order of Employment.

… The application shall state the **specific facts** showing the necessity for the employment, the 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**. The application shall be accompanied by a **verified statement of the person to be employed setting forth 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.

QUESTION

TRUE OR FALSE

Rule 2014 disclosures are only intended to capture "actual" or "potential" conflicts.

ANSWER

FALSE

Disclosures are intended to capture "connections" and not just "actual" or "potential" conflicts.

In re eToys, Inc., 331 B.R. 176, 196 (Bankr. D. Del. 2005) ("[T]he 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.") (emphasis added)

In re Granite Partners, L.P., 219 B.R. 22, 35 (Bankr. S.D.N.Y. 1998) ("The scope of disclosure is much broader than the question of disqualification.")

DISCLOSURE OBLIGATIONS

- Purpose of Rule 2014 is to provide the Court and U.S. trustee with information to determine whether professional's employment is in "best interests of the estate …" *See e.g., Exco Res. v. Milbank (In re Enron Corp.)*, No. 02-CV-5638 (S.D.N.Y. Jan. 28, 2003).
- Rule 2014 is to be "strictly construed" and failure to disclose relevant connections is "an independent basis for the bankruptcy court to disallow fees or to disqualify the professional from the case." *See id.; see also Banner v. Cohen, Estis & Assocs., Ltd.*, 345 B.R. 87, 111 (Bankr. S.D.N.Y. 2006).

DISCLOSURE OBLIGATIONS

- The term "parties in interest" includes entities holding "claims" against the debtor and those whose pecuniary interests might be directly and adversely affected by the proposed action. *See In re Savage Indus.*, 43 F.3d 714, 720 (1st Cir. 1994); *In re El Comandante Mgmt. Co., LLC*, 395 B.R. 807, 817 (D.P.R. 2008).

DISCLOSURE OBLIGATIONS

- Rule 2014 does not limit the extent of disclosure of a professional's connections with the parties set out in the rule – the debtor, creditors of the debtor, other parties in interest, attorneys of the same, accountants of the same, and the U.S. trustee and persons employed by the U.S. trustee
- Courts find that professionals have little, if any, discretion in determining whether a connection is relevant to the employment application. *See generally In re Crivello*, 134 F.3d 831 (7th Cir. 1998).
- There has been confusion over the level of inclusiveness in disclosures
- Led to "phone book" sized disclosures where meaningful connections get lost

DISCLOSURE OBLIGATIONS

"One Percent" Rule for Representing Secured Creditors

- Courts have held that law firms should disclose if a secured creditor accounts for more than 1 percent of annual revenues. *See e.g., In re Rockaway Bedding, Inc.*, No. 04-14898, 2007 WL 1461319, at *4 (Bankr. D.N.J. May 14, 2007) (holding that no actual conflict of interest occurred when a secured creditor accounted for less than 1% of a law firm's revenues).
- Criticized because, for a large law firm, one percent of annual revenues can be enormous amount of money
- Best practice is to disclose additional information, including size of the case, the number of active parties involved, the amount of the secured creditor's claim, when the secured loan was made, what law firm documented the loan, what issues are likely to arise regarding the secured creditor's claim, the actual revenues that the secured lender represents to the firm, the size of the firm, and who at the firm provides legal services on behalf of the secured creditor. See "The 1 Percent Rule Needs Fixing," Kenneth A. Rosen, Esq.

QUESTION

TRUE OR FALSE

An insufficient disclosure requires disqualification of the estate professional.

ANSWER

FALSE

"Courts have generally declined to formulate bright-line rules concerning the criteria for disqualification, favoring instead an approach which evaluates the facts and circumstances of each particular case."
In re Leslie Fay Cos, Inc., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994) (quotation omitted)

Further, a delay in bringing a disqualification motion could amount to a waiver of the right to contest an alleged conflict of interest.
See KLG Gates LLP v. Brown, 506 B.R. 177, 192 (E.D.N.Y. 2014)

DISCLOSURE OBLIGATIONS

***In re The Leslie Fay Cos., Inc.*, 175 B.R. 525 (Bankr. S.D.N.Y. 1994)**

- Prepetition, audit committee had investigated misstatements in financial disclosures by company's management.
- Proposed debtors' counsel had prepetition represented (1) the audit committee in third-party securities fraud actions, (2) directors who were potential targets of investigation, and (3) large companies where directors were senior officers or general partners.
- Law firm failed to disclose these potential conflicts
- Court held that failure to disclose potential conflicts that might have impaired its investigation into fraud by management warranted monetary sanctions in the amount of cost of investigating counsel's performance, but not disqualification

DISCLOSURE OBLIGATIONS

***In re The Leslie Fay Cos., Inc.*, 175 B.R. 525 (Bankr. S.D.N.Y. 1994)**

- Potential conflicts: "Potential conflicts, no less than actual ones, can provide motives for attorneys to act in ways contrary to the best interests of their clients. Rather than worry about the potential/actual dichotomy it is more productive to ask whether a professional has 'either a **meaningful incentive to act contrary to the best interests of the estate and its sundry creditors—an incentive sufficient to place those parties at more than acceptable risk—or the reasonable perception of one**.'" *Id.* at 533 (internal citation omitted).

QUESTION

TRUE OR FALSE

A Court may disqualify a professional based on the appearance of a conflict alone.

ANSWER

FALSE

"Attorneys with actual conflicts face *per se* disqualification, but disqualification is at the court's discretion for attorneys with potential conflicts. And a court may not disqualify an attorney on the appearance of conflict alone."

In re Boy Scouts of Am., 35 F.4th 149, 158 (3d Cir. 2022)
(citing and quoting *In re Marvel Ent. Grp., Inc.*, 140 F.3d 463, 476 (3d Cir. 1998))
(internal quotation marks omitted) (emphasis added)

DISCLOSURE OBLIGATIONS

***Caesars Ent. Op. Co., Inc.*, No. 15-01145 (Bankr. N.D. Ill.)**

- Issue: when does representation of affiliates of equity interest holders constitute a disqualifying adverse interest?
- Affiliates of private equity firms Apollo and TPG controlled debtor's parent
- Debtor's counsel represented, on unrelated matters, other portfolio companies of Apollo and TPG.
  - *The firm disclosed that 3.4% of annual revenue was on account of Apollo and TPG-related work.*
  - *The firm also represented TPG principal (who was also debtor's director) in an unrelated securities litigation*
- Court approved the firm's employment. The court held that the representations raised a "potential conflict" only, which did not require disqualification.

DISCLOSURE OBLIGATIONS

***Caesars Ent. Op. Co., Inc.*, No. 15-01145 (Bankr. N.D. Ill.)**

- Financial consultant was hired to investigate allegations of asset-stripping by Caesar's parent company. In February 2015, the company and lead CPA Jane Doe filed Rule 2014 disclosures.
- At the time, Doe was having an extramarital affair with an attorney who represented the parent company. She did not disclose this in the filing.
- Later, an attorney from the U.S. Trustee's office had a "chance encounter" with the pair in a social setting.
- Two weeks later, the company disclosed the relationship to the court and removed Doe from the case.
- The court nevertheless decided to discard the results of the investigation by the company, saying that the investigation was "tainted" by Doe's "sleeping with the enemy."

QUESTION

TRUE OR FALSE

An inadvertent failure to disclose a connection can result in disgorgement of fees, even if there is no harm to the estate.

ANSWER

TRUE

"Failure to disclose may result in disallowance of fees . . . , even if the failure was negligent and not willful."
In re eToys, Inc., 331 B.R. 176, 197 (Bankr. D. Del. 2005)
(citing *In re BH & P, Inc.*, 949 F.2d 1300, 1318 (3d Cir. 1991))

Harm to the estate is not necessary to a decision to order disgorgement of fees where there is a conflict of interest.
In re Leslie Fay Cos., 175 B.R. 525, 531 (Bankr. S.D.N.Y. 1994)

DISCLOSURE OBLIGATIONS

Potential for criminal liability

- Some ethical violations may be criminal and carry penalties of fines and possible imprisonment
- 28 U.S.C. sec. 157: a person who files a document in a chapter 11 proceeding who has "devised or intend[s] to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice . . . shall be fined under this title, imprisoned not more than 5 years, or both . . . ."

A Cautionary Tale

- John Doe, a partner at a large New York law firm, represented a company in its Chapter 11 bankruptcy.
- Doe filed a "Rule 2014" declaration that failed to list a senior secured creditor and related parties that the firm (and Doe) represented (in part, concurrently with the chapter 11 case). Evidence indicated that Doe had knowledge of the connections and acted either recklessly or intentionally with respect to his failure to disclose.
- Doe was charged with
  - two counts of knowingly and fraudulently making a false material declaration in violation of 18 U.S.C. § 152; and
  - one count of using a document while under oath, knowing that it contained a false material declaration, in violation of 18 U.S.C. § 1623.
- After a six-day trial, the jury returned guilty verdicts on all three counts and Doe was sentenced to **15 months of imprisonment on each count**, to run concurrently, and was fined $15,000.

QUESTION

TRUE OR FALSE

Rule 2014 requires supplemental or continuing disclosure.

ANSWER

FALSE

"Rule 2014(a) does not expressly require supplemental or continuing disclosure. Nevertheless, section 327(a) implies a duty of continuing disclosure, and requires professionals to reveal connections that arise after their retention."

In re Granite Partners, L.P., 219 B.R. 22, 35 (Bankr. S.D.N.Y. 1998) (internal citations omitted) (emphasis added)

DISCLOSURE OBLIGATIONS

- In 2013, the American Bankruptcy Institute Ethics Task Force proposed amendments to Rule 2014 that would (1) provide clarity to professionals concerning what relevant connections must be disclosed, and (2) provide improved information for courts and other parties reviewing the disclosures.
- The Subcommittee on Attorney Conduct and Healthcare of the Advisory Committee on Bankruptcy Rules (a judicial committee) considered the proposed amendment, but rejected it in August 2015.
  - *The Subcommittee noted that such proposals could be implemented as best practices by the US Trustee, courts or practitioners without a rule amendment or official form.*

DISCLOSURE OBLIGATIONS

TAKE-AWAYS

- Err on the side of over-disclosure
- "Phone book" approach may still be a model. Professionals should use their memorandum of law supporting their retention application to highlight relevant connections
- "Boiler plate" language may be helpful but isn't a substitute for actual disclosures
- Should supplement disclosures on a regular basis
- Conflicts counsel can be used to deal with conflicts that would otherwise be disabling

OVERVIEW

- **State ethics rules do not always fit the realities of bankruptcy practice. Numerous parties with shifting allegiances; different from two-party adversarial matter.**
- **Courts have recognized that the model rules promulgated by the ABA may be "ill-adapted" to bankruptcy proceedings, where "administrative matters rather than litigation may be the focus of an attorney's work." *In re Nguyen*, 447 B.R. 268, 277 (9th Cir. B.A.P. 2011).**
- **Congress imposed additional ethical requirements in the Bankruptcy Code:**
  - Section 327: proposed counsel for the trustee should have no "interest adverse to the estate" and should be "disinterested persons"
  - "[I]n the bankruptcy context we are not constrained simply by the Code of Professional Responsibility but by the Bankruptcy Code itself." *In re The Leslie Fay Cos., Inc.*, 175 B.R. 525, 538 (Bankr. S.D.N.Y. 1994)

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DISCLOSURE OBLIGATIONS

- **Sections 327 and 1103 of the Bankruptcy Code set forth specific standards that proposed professionals must meet to be retained as an estate or committee professional.**
- **They require the professional to meet certain standards of independence from parties other than their client.**
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- **Purpose of Rule 2014 is to provide the Court and U.S. trustee with information to determine whether professional's employment is in "best interests of the estate . . ." *See e.g., Exco Res. v. Milbank (In re Enron Corp.)*, No. 02-CV-5638 (S.D.N.Y. Jan. 28, 2003).**
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- At the time, Knoll was having an extramarital affair with Vincent Lazar, an attorney who represented the parent company. She did not disclose this in the filing.
- Later, an attorney from the U.S. Trustee's office had a "chance encounter" with the pair in a social setting.
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DISCLOSURE OBLIGATIONS

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- The Subcommittee on Attorney Conduct and Healthcare of the Advisory Committee on Bankruptcy Rules (a judicial committee) considered the proposed amendment, but rejected it in August 2015.
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TAKE-AWAYS

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- **Should supplement disclosures on a regular basis**
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Faculty

Scott F. Gautier is a partner with Faegre Drinker Biddle & Reath LLP in Los Angeles, where he represents corporate clients in financial distress, with the goal of creating and structuring transactions that maximize value for clients. He counsels corporate owners, boards, fiduciaries and creditors on all facets of corporate insolvency and handles corporate chapter 11 cases from every vantage point — as counsel to debtors, ad-hoc and official committees, secured creditors and other constituents. He also works on out-of-court financial restructuring matters, distressed mergers and acquisitions, and advises corporate clients on debtor-creditor issues in nonbankruptcy matters. Mr. Gautier has represented all constituents in corporate restructuring, with particular experience advising corporate owners, boards and fiduciaries on identifying the best strategic alternatives when faced with financial distress, and serving as lead committee counsel and advising on strategic alternatives in corporate chapter 11 cases. Before joining Faegre Drinker, he chaired a corporate restructuring and bankruptcy group at a national law firm. Mr. Gautier is a former director of ABI and the Southern California Turnaround Managers Association, and he is active in the Financial Lawyers Conference. He regularly writes and speaks on financial restructuring and insolvency issues for local and national conferences, and he has been listed in *Chambers USA*, *The Best Lawyers in America*, *Lawdragon* and *Super Lawyers*. Mr. Gautier received his B.S.B.A. from Ohio State University and his J.D. with highest honors from the Chicago-Kent College of Law, where he was elected to the Order of the Coif.

Ferve E. Khan is a bankruptcy and restructuring attorney in the New York office of BakerHostetler, where her practice includes both plaintiff and defense-side litigation and transactional work. She has particular experience in the financial services, energy and health care industries. She also has represented creditors, committees and fiduciaries in cases of mass torts, the recovery of the proceeds of fraud, and chapter 11. In 2020, Ms. Kahn was named one of ABI's "40 Under 40." In addition, she is a Fellow of the American Bar Foundation. Ms. Khan received her B.A. in political science *magna cum laude* in 2005 from Brown University, and her J.D. in 2008 from Cornell University Law School, where she served as articles editor for the *Cornell International Law Journal* and managing editor of the *Legal Information Institute Bulletin*.

Jaclyn C. Marasco is a partner with Faegre Drinker Biddle & Reath LLP in Wilmington, Del., and is a corporate restructuring attorney and litigator experienced with high-profile bankruptcy cases and complex commercial litigation with a nexus to the state of Delaware. Having served as a trial attorney for the Office of the U.S. Trustee in Delaware and as a law clerk to two U.S. bankruptcy judges in New York and Delaware, she is familiar with complex chapter 11 proceedings and their impact on various stakeholders. Ms. Marasco devises strategies for client debtors, creditors and committees, court-appointed fiduciaries, and other parties in interest in high-stakes bankruptcy cases and related litigation. In addition, she participated in the National Conference of Bankruptcy Judges' 2022 Next Generation Program (NextGen) and made the firm's *Pro Bono* Honor Roll in 2021. Ms. Marasco received her B.S. *cum laude* in business administration in 2011 from the State University of New York at Geneseo and her J.D. *cum laude* from Pace University School of Law in 2014, where she served as executive articles editor of the *Pace Law Review*.

Hon. Jerrold N. Poslusny, Jr. is a U.S. Bankruptcy Judge for the District of New Jersey in Camden, appointed in June 2015. Prior to his appointment, he clerked for Hon. E. Stephen Derby and Hon. James F. Schneider, U.S. Bankruptcy Judges for the District of Maryland, then worked as an associate and member with the firm of Cozen O'Connor P.C. in Cherry Hill, N.J. He then was a shareholder of Sherman, Silverstein, Kohl, Rose & Podolsky, P.A. in Moorestown, N.J., where he concentrated his practice in bankruptcy law, workouts and commercial litigation. Judge Poslusny is admitted to the state bars and district courts of Delaware, Maryland and New Jersey, and the Third and Fourth Circuit Courts of Appeal. He is a member of the National Conference of Bankruptcy Judges, ABI and the Association of Insolvency and Restructuring Advisors, where he is a Distinguished Fellow. He has served as an editor, author and frequent lecturer to professional and educational organizations. Judge Poslusny received his B.S. from Pennsylvania State University and his J.D. from the University of Maryland School of Law.

Andrew R. Vara is the U.S. Trustee for Regions 3 and 9 in Cleveland, which encompass 10 field offices in Delaware, New Jersey, Pennsylvania, Ohio and Michigan. He has worked for the U.S. Department of Justice for 30 years, serving as a trial attorney, Assistant U.S. Trustee in Cleveland and Wilmington, Del., and the acting assistant U.S. Trustee in both the Southern District of New York and Western District of Michigan. Following law school, Mr. Vara clerked for Hon. Laurence Howard, Chief Judge for the U.S. Bankruptcy Court in Grand Rapids, Mich. He also is a regular faculty member and lecturer at training seminars held at the National Advocacy Center in Columbia, S.C. Mr. Vara has been a panelist at numerous ABI conferences, including its Annual Spring Meeting, Winter Leadership Conference, Mid-Atlantic Bankruptcy Workshop and Central States Bankruptcy Workshop. He was a member of the ABI's Ethics Task Force and chaired ABI's Ethics and Professional Compensation Committee. Mr. Vara served as a presenter on U.S. and international insolvency law at forums sponsored by the Commercial Law Development Program in Bahrain and the Kingdom of Saudi Arabia. He received his B.A. *magna cum laude* in political science from Duke University and his J.D. with honors from The Ohio State University in May 1991, where he was awarded membership in the Order of the Coif.