Views from the Bench, 2018

AMERICAN
BANKRUPTCY
INSTITUTE

Ethics

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Bankruptcy 2018: Views From The Bench
Georgetown University Law Center
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"Ethics: Conflicts, Disclosure, Fees and More..."

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Ethical considerations continue to be a challenge for all of us. And bankruptcy professionals, in particular, face even greater challenges when one takes into account the various requirements imposed by the Bankruptcy Code (including "disinterestedness" and lack of an "adverse interest" set forth in Sections 327, 328 and 330), as well as those established by Bankruptcy Rules 2014 and 2019 with respect to disclosure of "connections", and beyond. The Ethics panel will explore these topics, and more, in the context of the Model Rules of Professional Conduct, including RPCs 1.6 ("Confidentiality of Information"), 1.7 ("Conflict of Interest: Current Clients"), 1.9 ("Duties to Former Clients"), 1.18 ("Duties to Prospective Client"), 3.3 ("Candor Toward the Tribunal"), and 4.1 ("Truthfulness in Statements to Others"). The panel will also address the current state of affairs with respect to allowance of fees incurred in defending fee applications and the use of in camera disclosures in conjunction with retention-related issues.[1]

I. Confidentiality of Information

A. New Jersey RPC 1.6 Confidentiality of Information

1. *Excerpt:*

(a) A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation, and except as stated in paragraphs (b), (c), and (d).

(b) A lawyer shall reveal such information to the proper authorities, as soon as, and to the extent the lawyer reasonably believes necessary, to prevent the client or another person:

(1) from committing a criminal, illegal or fraudulent act that the lawyer reasonably believes is likely to result in death or substantial bodily harm or substantial injury to the financial interest or property of another;

(2) from committing a criminal, illegal or fraudulent act that the lawyer reasonably believes is likely to perpetrate a fraud upon a tribunal.

(c) If a lawyer reveals information pursuant to RPC 1.6(b), the lawyer also may reveal the information to the person threatened to the extent the lawyer reasonably believes is necessary to protect that person from death, substantial bodily harm, substantial financial injury, or substantial property loss.

[1] We gratefully acknowledge the tremendous assistance of Laura Gronauer, BakerHostetler Summer Associate, in connection with the preparation of these materials.

(d) A lawyer may reveal such information to the extent the lawyer reasonably believes necessary:

(1) to rectify the consequences of a client's criminal, illegal or fraudulent act in the furtherance of which the lawyer's services had been used;

(2) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, or to establish a defense to a criminal charge, civil claim or disciplinary complaint against the lawyer based upon the conduct in which the client was involved; or

(3) to prevent the client from causing death or substantial bodily harm to himself or herself; or

(4) to comply with other law.

(e) Reasonable belief for purposes of RPC 1.6 is the belief or conclusion of a reasonable lawyer that is based upon information that has some foundation in fact and constitutes prima facie evidence of the matters referred to in subsections (b), (c), or (d).

II. Candor Toward the Tribunal

A. **Illinois RPC 3.3 Candor Toward the Tribunal**

1. *Excerpt:*

(a) A lawyer shall not knowingly:

(1) Make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer;

(2) fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel; or

(3) offer evidence that the lawyer knows to be false. If a lawyer, the lawyer's client, or a witness called by the lawyer, has offered material evidence and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal. A lawyer may refuse to offer evidence, other than the testimony of a defendant in a criminal matter, that the lawyer reasonably believes is false.

B. Representations and Waivers

1. *Excerpt* from **D.C. RPC 1.7(a) Conflict of Interest: General Rule**

"[A] lawyer shall not advance two or more adverse positions in the same matter."

This is a non-waivable rule.

2. And **D.C. RPC 1.7(b)(4)**

"A lawyer shall not represent a client with respect to a matter if . . . [t]he lawyer's professional judgment on behalf of the client will be or reasonably may be adversely affected by the lawyer's responsibilities to or interests in a third party or the lawyer's own financial, business, property, or personal interest."

This is a waivable rule, but a waiver must be executed.

3. *Excerpt* from **Connecticut RPC 1.7 Conflict of Interest: Current Clients**

"[A] lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) 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."

III. Disclosure – Employment of Professional Persons

A. **Bankruptcy Rule 2014**

1. *Excerpt:*

(a) Application for an order of employment.

An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to § 327, § 1103, or § 1114 of the Code shall be made only on application of the trustee or committee. The application shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States trustee 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. [(Emphasis supplied.)]

2. In re Howard Avenue Station, 568 B.R. 146 (Bankr. N.D. Fla. 2017)

Special counsel failed to comply with disclosure obligations regarding fees and costs required by Section 329 and Rule 2016(b). Although the Court has discretion to deny all fees and costs, it ordered the return of only a portion of the fees because Special Counsel never represented a fiduciary of a bankruptcy estate before and a learning curve was warranted.

B. Disclosure of Connections: In re Alpha Natural Res., Inc., 556 B.R. 249 (Bankr. E.D. Va. 2016)

C. McKinsey & Co. – "The Jay Alix Objections"

D. In re Nine W. Holdings, Inc., No. 18-10947, 2018 WL 3238695 (Bankr. S.D.N.Y July 2, 2018)

E. In re Relativity Media, LLC, No. 18-11358, 2018 Bankr. LEXIS 2037 (Bankr. S.D.N.Y. July 6, 2018) (holding that law firm could not handle portions of bankruptcy disputes involving Netflix, a current client in an unrelated matter and that series of engagement letters and emails did not constitute an advance waiver of conflicts; Court required retention of conflicts counsel).

F. In re Ortega's Mexican Restaurant, LLC and Pablo Ortega, (Bankr. D. Conn, June 18, 2018) (Case No. 18-20306/20308 – JJT) (interim order on restaurant's motion for proposed dual representation of the restaurant and Ortega granted, subject to conditions) (equal access to the courts "requires practicality, balanced scrutiny, and a reasonable opportunity to avail oneself of the prospect to reorganize under judicial review. Mechanistic retention or disqualification formulas should not impair access to the courts. …") (Copy attached.)

G. In re Cloudeeva, Inc. (Bankr. D.N.J.) (Case No. 14-24874-KCF) (Doc. 475, excerpted transcript of hearing on 02/13/2015) (trustee removed for cause due to failure to disclose all known "connections")

H. B H & P Inc., 949 F.2d 1300 (3d Cir. 1991)

I. In re Status Game Corp., 102 B.R. 19 (Bankr. D. Conn. 1989)

IV. Disclosure Regarding Creditors and Equity Security Holders in Chapter 9 and Chapter 11 Cases

A. **Bankruptcy Rule 2019**

1. *Excerpt:*

(b) Disclosure by groups, committees, and entities

(1) In a chapter 9 or 11 case, a verified statement setting forth the information specified in subdivision (c) of this rule shall be filed by every group or committee that consists of or represents, and every entity that represents, multiple creditors or equity security holders that are (A) acting in concert to advance their common interest, and (B) not composed entirely of affiliates or insiders of one another.

. . . .

(d) Supplemental statements

If any fact disclosed in its most recently filed statement has changed materially, an entity, group, or committee shall file a verified supplemental statement whenever it takes a position before the court or solicits votes on the confirmation of a plan. The supplemental statement shall set forth the material changes in the facts required by subdivision (c) to be disclosed.

V. Transactions with Persons Other Than Clients

A. **Illinois RPC 4.1 Truthfulness in Statements to Others**

1. *Excerpt:*

In the course of representing a client a lawyer shall not knowingly:

(a) make a false statement of material fact or law to a third person; or

(b) fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.

B. In re Banco Santos, S.A., 2014 WL 5655025 (Bankr. S.D. Fla. Nov. 3, 2014) (attached).

1. Decision, following evidentiary hearing on defendant Bank's Amended Motion for Disqualification of Counsel for plaintiff Trustee as a result of alleged improper elicitation of privileged material from former and current

employees of Bank, as well as *ex parte* communications with two former employees, purportedly in violation of Florida Rules of Professional Conduct. Although the Motion was ultimately denied, the Court described the matter as follows:

> "This dispute involves, at best, an unfortunate breakdown in communication; at worst, a violation of various rules of the Florida Rules of Professional Conduct . . . and, at a minimum, a disappointing lack of professionalism."

2. In reaching its decision, the Court considered Rule 4-4.2; Rule 4-4.3; Rule 4-4.4; Rule 4-8.4; Rule 4-3.4; and Rule 4-4.1.

C. **Connecticut RPC 1.18 Duties to Prospective Client**

1. *Excerpt:*

(a) A person who consults with a lawyer concerning the possibility of forming a client-lawyer relationship with respect to a matter is a prospective client.

(b) Even when no client-lawyer relationship ensues, a lawyer who has learned information from a prospective client shall not use or reveal that information, except as Rule 1.9 would permit with respect to information of a former client.

(c) A lawyer subject to subsection (b) shall not represent a client with interests materially adverse to those of a prospective client in the same or a substantially related matter if the lawyer received information from the prospective client that could be significantly harmful to that person in the matter, except as provided in subsection (d). If a lawyer is disqualified from representation under this paragraph, no lawyer in a firm with which that lawyer is associated may knowingly undertake or continue representation in such a matter, except as provided in subsection (d).

VI. Client-Lawyer Relationship

A. **Illinois RPC 1.9 Duties to Former Clients**

1. *Excerpt:*

(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent.

(b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client

(1) whose interests are materially adverse to that person; and

(2) about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(c) that is material to the matter; unless the former client gives informed consent.

(c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:

(1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or

(2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.

B. Ethics Opinion 284: Advising And Billing Clients For Temporary Lawyers (September 1998) (Bar of the District of Columbia) (addressing Rules 1.2, 1.4, 1.5, 7.1 and 7.5 of the D.C. Bar)

C. In re Vincent D'Arata (Bankr. S.D.N.Y. August 3, 2018)(Case No. 18-10524-SHL) (Memorandum Decision Regarding The Disgorgement Of Atty's Fees based upon, *inter alia*, issues related to use of "Appearance Counsel")

VII. Fees

A. **New Jersey RPC 1.5 Fees**

1. *Excerpt:*

(a) A lawyer's fee shall be reasonable. The factors to be considered in determining the reasonableness of a fee include the following:

(1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;

(2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;

(3) the fee customarily charged in the locality for similar legal services;

(4) the amount involved and the results obtained;

(5) the time limitations imposed by the client or by the circumstances;

(6) the nature and length of the professional relationship with the client;

(7) the experience, reputation, and ability of the lawyer or lawyers performing the services;

(8) whether the fee is fixed or contingent.

B. Baker Botts L.L.P. v. ASARCO LLC, 576 U.S. ___, 135 S. Ct. 2158 (2015) (holding that Bankruptcy Code section 330(a)(1) does not permit bankruptcy courts to award fees to professionals retained under section 327(a) for defending fee applications).

1. In re Boomerang Tube, Inc., 548 B.R. 69 (Bankr. D. Del. 2016) (holding that committee counsel could not contract around ASARCO)

   Objections by Office of the U.S. Trustee to "fee defense provisions" included as part of proposed retention of Alvarez & Marshal North America LLC, and law firms Brown Rudnick LLP and Morris Nichols Arsht & Tunnell LLP by Official Creditors' Committee.

2. Bletchley Hotel at O'Hare Field LLC v. River Road Hotel Partners, LLC, 2016 WL 4146480 (N.D. Ill. Aug. 4, 2016) (rejecting a financial advisor's argument that its retention order overrides the default American rule, because the order stated that fee-defense reimbursement was subject to the court's review and approval pursuant to § 330, which does not permit recovery of such fees).

3. In re Hungry Horse, LLC, 574 B.R. 740 (Bankr. D.N.M. 2017) (holding that ASARCO did not preclude inclusion of a fees-defense provision in retention of debtor's counsel).

4. In re Northshore Mainland Services Inc., Case No. 15-11402 (KJC) (Bankr. D. Del.) (the "Baha Mar Resort") (Court asked the parties to submit briefs on the issue, but approved the Committee's request to retain Whiteford Taylor without a fee defense provision, saying that it would revisit the issue later)

   Objection by Office of U.S. Trustee to fee defense provision in agreement of Whiteford Taylor Preston LLP to represent Official Creditors' Committee.

5. In re Stanton, 559 B.R. 781 (Bankr. M.D. Fla. 2016)

   ASARCO did not preclude professional from being paid fees to supplement fee application after U.S. Trustee objection had been filed because supplement was a service to the estate by explaining time spent by special counsel where such supplement was not initially routinely required in chapter 7 special counsel fee application. Thus, ASARCO did not recreate temporal restriction on being paid fees but, rather, focused on whether fees incurred post-objection are for the benefit of the estate.

6. In re Rothenbush, 2017 WL 933019 (Bankr. M.D. Fla., Feb. 22, 2017)

   U.S. Trustee waived its ASARCO objection to supplemental fee request, finding that the Supreme Court's ruling was consistent with long-standing Eleventh Circuit precedent, so the objection raised by the UST was available even if the ASARCO decision had not intervened.

C. Section 327. Employment of Professional Persons

1. *Excerpt:*

   (a) Except as otherwise provided in this section, the trustee, 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 duties under this title.

D. Section 328. Limitation on Compensation of Professional Persons

1. *Excerpt:*

   (a) The trustee, or a committee appointed under section 1102 of this title, with the court's approval, may employ or authorize the employment of a professional person under section 327 or 1103 of this title, as the case may be, on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis. Notwithstanding such terms and conditions, the court may allow compensation different from the compensation provided under such terms and conditions after the conclusion of such employment, if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions.

E. Section 330 of the Bankruptcy Code provides for compensation of all professionals whose retention is approved by the court.

1. Specifically, section 330(a) provides, in relevant part:

   [T]he court may award to a trustee, a consumer privacy ombudsman appointed under section 332, an examiner, an ombudsman appointed under section 333, or a professional person employed under section 327 or 1103

(A) reasonable compensation for actual, necessary services rendered by the trustee, examiner, ombudsman, professional person, or attorney and by any paraprofessional person employed by any such person; and

(B) reimbursement for actual, necessary expenses.

F. Ethical billing practices:

1. Ethical implications

2. Overlapping

3. Gordon, Randy D. and Nancy B. Rapoport, "Virtuous Billing", 15 *Nevada Law Journal* 698. (Spring 2015).

G. Risks posed by lack of disclosure to the award of fees or disgorgement

1. In re Earl Gaudio & Son, Inc., No. 13-90942, 2018 WL 3388917 (Bankr. C.D. Ill. July 10, 2018) (reducing a law firm's requested $1,821,048.95 in fees and costs to $691,769.28 based on lack of detail, use of generic terms, bad math, overuse of redactions, unsubstantiated charges, and ignoring prior admonishment for the same issues in an earlier fee application).

H. Administrative insolvency implications and possible "solutions"

1. See attached "Getting Paid And Avoiding Disgorgement: Who Pays The Freight In A Section 363 Sale?" by Paul R. Hage, Esq. (Jaffe Raitt Heuer & Weiss, P.C.)[2]

[2] Originally published in connection with the ABI 2018 Central States Bankruptcy Workshop.

UNITED STATES BANKRUPTCY COURT
DISTRICT OF CONNECTICUT
HARTFORD DIVISION

IN RE:	:	CHAPTER 11
	:	
ORTEGA'S MEXICAN RESTAURANT, LLC and PABLO ORTEGA	:	Case No. 18-20306 (JJT) 18-20308 (JJT)
	:	
DEBTORS.	:	Re: ECF Nos. 11, 40, 46

INTERIM ORDER ON RESTAURANT'S MOTION FOR RETENTION OF DEBTOR'S COUNSEL

I. INTRODUCTION

Pending before the Court is the Application to Employ David F. Falvey and Action Advocacy Law Office, P.C. as Counsel ("Application", ECF No. 11) filed by Ortega's Mexican Restaurant, LLC ("Restaurant") and the corresponding Statement of Objection filed by the United States Trustee (ECF No. 40). Both the Restaurant and Pablo Ortega ("Ortega") filed a reply (ECF No. 46), requesting approval for the proposed eventual dual representation of the Restaurant and Ortega.[1] For the reasons set forth below, the Court issues an interim order approving the Application, subject to the further direction specified herein.

II. FACTUAL SUMMARY

This case involves two Chapter 11 debtors: the Restaurant and Ortega. On April 6, 2018, this Court entered an Order (ECF No. 28) granting the Motion for Joint Administration filed by the Restaurant (ECF No. 10). The Application pending before the Court requests the approval of

[1] The Application discloses this objective, but no separate application for Ortega's counsel is currently on file with the U.S. Bankruptcy Court for the District of Connecticut.

employment of one proposed counsel, namely David F. Falvey and Action Advocacy Law Office, P.C. (collectively, "Attorney Falvey"), for both the Restaurant and Ortega.

A. Organizational Formalities

Ortega opened the Restaurant as a Connecticut limited liability company ("LLC") in 2002. Ortega is the sole member of the Restaurant.[2] The Restaurant, allegedly formed as an LLC for tax purposes, asserts that it is short on compliance with financial discipline and maintaining legal separateness and formalities. The Restaurant allegedly fell upon financial difficulties as a result of improvident borrowings and the failure of a sister operation. Ortega, his wife, and his daughter are all employees of the Restaurant. Ortega personally owns the land the Restaurant occupies pursuant to an undocumented lease. Ortega is also the landlord to the Restaurant and is, arguably, one of its creditors. According to Ortega, the Restaurant is his sole source of income and provides the wages for his familial employees. It is the natural and only cash flow resource[3] to fund any potential reorganization for both the Restaurant and Ortega personally. Ortega and his family allegedly work tirelessly to maintain this livelihood and business.

There is a significant commonality of interests between both the Restaurant and Ortega due to the substantial overlap in prepetition general unsecured debt, which was mostly generated by Restaurant operations or guaranteed business debt. To date, no creditor of either estate has filed objections to the Application or appeared at hearings related to these cases. There is a material, mutual, and interrelated functional and financial dependency between the two Chapter 11 estates and their affairs. The reorganization of the Restaurant business would provide the only material

[2] This is confirmed by the Restaurant's filing with the Secretary of State. Office of Sec'y of the State, https://www.concord-sots.ct.gov/CONCORD/online?sn=PublicInquiry&eid=9740 (last visited June 18, 2018).

[3] Ortega's real property may have equity if fair value, as opposed to liquidation value, can be achieved, taking into account real property taxes, exemption claims, maintenance costs, transactional disposition fees, capital gains, and transfer taxes. Such "equity" could be a source of recovery for Ortega's individual creditors.

resource for Ortega's living expenses and for funding of any reorganization plan in each Chapter 11 case.

With that in mind, these Chapter 11 cases manifestly invite some form of a consolidated plan approach (which has already been suggested by Attorney Falvey) if the cases are to feasibly reorganize within a reasonable period of time.

III. DISCUSSION

Here, the Court must decide in this context whether there is currently any actual conflict of interest between the debtors preventing Attorney Falvey's proposed dual representation by the Restaurant and Ortega. While disclosed potential conflicts assuredly exist, at this juncture the Court finds that it is premature to conclude that those conflicts cannot be reconciled in a consensual, possibly unopposed, consolidated, coordinated plan, or otherwise, providing for fair and appropriate treatment of all constituent interests. The liquidation alternatives are patently unpromising for the Restaurant, Ortega, and the unsecured creditors. It is the interdependence of these debtors and the prospects of a joint plan that confirm that the identified conflicts, at this early stage, are potential and not yet actual.

A. Law

Section 327(a) of the United States Bankruptcy Code creates a two-part test in order to employ counsel to represent the debtor's estate. To pass the test, counsel must: (1) "not hold or represent an interest adverse to the estate," and (2) must be "disinterested". 11 U.S.C. § 327(a) (1978). The two-part test overlaps. *In re CF Holding Corp.*, 164 B.R. 799, 806 (Bankr. D. Conn. 1995). The Application must pass a "fact and circumstances" test, which differs on a case-by-case basis. *In re AroChem Corp.*, 176 F.3d 610, 623 (2d Cir. 1999).

Under Section 327(c) of the Code, "a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an *actual* conflict of interest." 11 U.S.C. § 327(c) (1978) (emphasis added). Where there is an objection to the retention of proposed debtor's counsel and an *actual* conflict of interest exists, the court must disapprove the employment of counsel. *In re Project Orange Assocs., LLC*, 431 B.R. 363, 371 (Bankr. S.D.N.Y. 2010) (citing *AroChem II*, 176 F.3d at 621). Here, the United States Trustee has interposed an extensive objection. The burden rests on the objecting party to prove an actual conflict of interest exists. *In re Homesteads Cmty. at Newtown, LLC*, 390 B.R. 32, 48 (Bankr. D. Conn. 2008).

i. Adverse Interest

"Adverse interest" in undefined by the Bankruptcy Code, but through the common law has come to mean: "1) to possess or assert 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 is a rival claimant; or 2) to possess a predisposition under circumstances that render such a bias against the estate." *CF Holding*, 164 B.R. at 806.

Whether an adverse interest exists "ultimately turns on whether the particular facts at issue within the scope of the proposed employment call into question the incentive of counsel to act with undivided loyalty to the estate." *In re AroChem Corp.*, 181 B.R. 693, 700 (Bankr. D. Conn. 1995), *subsequently aff'd*, *AroChem II*, 176 F.3d at 610. "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. . . . In other words, if it is plausible that the representation of another interest may cause the debtor's attorneys to act differently than they would without that other representation, then they have a conflict and an interest adverse to the estate." *In re Leslie Fay Cos., Inc.*, 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994) (emphasis added) (citing *AroChem I*, 181 B.R. at 700).

"Potential conflicts range from mere possibilities to reasonably anticipated probabilities. If it is determined that the latter end of that continuum is implicated, a court need not wait until the inevitable result actually occurs to disqualify counsel. If, however, the conflict is merely theoretical, and its occurrence is merely speculative, disqualification *ex ante* is not necessary." *AroChem I*, 181 B.R. at 700. Inherent in the Bankruptcy Code are protections like Section 328(c) to safeguard estates should actual conflicts emerge from potential conflicts.

Where a small business[4] with a single owner is involved, "the interests of the individual and the company are almost always aligned because the success of each depends on the success of the other." Jeffrey M. Sklarz and Nicholas W. Quesenberry, *Can the Same Counsel Represent Both a Chapter 11 DIP and the Debtor's Sole Equity Owner?*, Am. Bankr. Inst. L.J. 44, 77 (2015). Here, that alignment for mutual success is a demonstrable and compelling incentive for debtors' counsel to serve the mutual interests of these debtors. If, for example, the property owned by Ortega is foreclosed upon, then the Restaurant would be forced to close and unable to fund its reorganization plan in much the same way that if the Restaurant is forced to close, then Ortega and his family will

[4] The Bankruptcy Code defines a small business debtor as "a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than $2,566,050 (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor; and does not include any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than $2,566,050 (excluding debt owed to 1 or more affiliates or insiders)." 11 U.S.C. § 101(51D)(A)-(B) (1994).

be unemployed and face abject financial circumstances, leaving Ortega unable to fund his own reorganization plan and at risk of losing his house as well. This circle of success presents no actual conflict *at this time*, permitting the dual representation of Ortega and the Restaurant until an actual conflict arises. Attorney Falvey's incentive, as counsel, is to act with undivided loyalty towards both clients' estates to ensure the success of both.

Attorney Falvey is not currently making any assertion that either Chapter 11 estate is economically adverse to the other, even if there are potential conflicts or claims due to the different legal hats that Ortega personally wears. "[M]erely hypothesizing that conflicts may arise is not a sufficient basis to warrant the disqualification" of an attorney. *In re Stamford Color Photo, Inc.*, 98 B.R. 135, 138 (Bankr. D. Conn. 1989). The Court will need to further examine whether an equitable reconciliation of those interests can be delivered—after the debtors are afforded an opportunity to advance a proposed solution.

ii. *Disinterested Persons*

The Bankruptcy Code defines a "disinterested person" as one who "is not a creditor, equity security holder, or an insider" and who "does not have an interest *materially* adverse to the interest of the estate or any class of creditors . . . by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason" 11 U.S.C. § 101(14)(A), (C) (emphasis added). A professional has a duty to disclose all facts that bear on disinterestedness pursuant to Rule 2014(a) of the Federal Bankruptcy Rules. *Leslie Fay*, 175 B.R. at 533. In order for the court to make its determination under Section 327 of the Bankruptcy Code and to uphold the integrity of the court, the court depends on "forthright disclosure" from the professional. *In re Granite Partners, L.P.*, 219 B.R. 22, 35 (Bankr. S.D.N.Y. 1998).

Ortega is not a secured creditor, nor is it necessarily ordained that he will ever be a creditor of the Restaurant. Attorney Falvey is neither a creditor, equity security holder, nor an insider of the Restaurant. Until the case progresses, the Court cannot determine whether Attorney Falvey has any interest that is materially adverse to the Restaurant by virtue of representing Ortega. For example, if the debtor's estates are consolidated into one plan, or if Ortega, as a potential creditor, disallows or subordinates his owed debts, then there is a high likelihood that there will never be an issue. Attorney Falvey's relationship with Ortega only becomes problematic if the Restaurant's reorganization is materially impaired by Ortega's claims, as opposed to assisted by his financial support or concessions.[5]

Attorney Falvey has been forthcoming to this Court about the potential conflicts between the debtors' estates that could arise over the course of these reorganizations. However, his duty to disclose interests does not end with the Court's ruling today. Instead, his disclosure obligations continue, and if an actual conflict is so realized, Attorney Falvey has a duty to promptly alert the Court, the United States Trustee, and the creditors. At that time, the Court will address the consequences of an actual conflict.

iii. The "Facts and Circumstances" Test

In cases like this, the inquiry is a fact-intensive one. Under the "facts and circumstances" test applied here, the conflicts, while discernible, are potential, not actual. The Court recognizes that Ortega's various legal statuses as landlord, employee, officer, equity holder, and potential creditor may give rise to positions adverse to the Restaurant. That adversity, however, is not now manifest and may be deferred, addressed in a joint plan, or otherwise averted or reconciled. The imposition

[5] The Court recognizes that restaurant reorganizations are notoriously difficult and often fail on account of an absence of feasibility or due to the unbearable weight of Chapter 11 transaction costs. In such event, the conflicts will likely play out in liquidation scenarios with trustees.

of refiling alternatives for Ortega, as suggested by the United States Trustee, or the application of procedural contortions for a plan, or the mandating of separate and unaffordable legal counsel would assure a prompt and fatal demise of the reorganization prospects of both debtors.

The Court is also guided in this ruling, in part, by the custom and practice in this Circuit, particularly in large commercial Chapter 11 cases filed by affiliated debtors in bankruptcy courts in Connecticut and the Southern District of New York. In those cases, courts have approved the retention of common counsel and allowed the conflict concerns to unfold in order for the court and creditors to reasonably assess whether the conflicts materialize or are otherwise readily resolvable. That approach affords debtors an opportunity to examine whether other mechanisms (for example, special counsel, conflicts counsel, an examiner, a fairness hearing, a settlement, derivative standing, or some form of joint plan) can be utilized to address those conflicts that might otherwise appear unavoidable or irreconcilable.

B. The Constitutional Basis for Equal Access to the Courts

Access to justice and due process through the court system is a constitutional mandate. U.S. Const. amend. XIV, § 1. Inherent in that bundle of rights is the opportunity to choose one's own counsel. *In re Magna Prods. Corp.*, 251 F.2d 423, 424 (2d Cir. 1958). If such access is to be meaningful in this context, it requires practicality, balanced scrutiny, and a reasonable opportunity to avail oneself of the prospect to reorganize under judicial review. Mechanistic retention or disqualification formulas should not impair access to the courts. "[T]he discretion of the bankruptcy court must be exercised in a way that it believes best serves the objectives of the bankruptcy system. Among the ultimate considerations for the bankruptcy courts in making these decisions must be the protection of the interests of the bankruptcy estate and its creditors, and the efficient, expeditious, and economical resolution of the bankruptcy proceeding." *AroChem II*, 176

F.3d at 621 (citing *In re Harold & Williams Dev. Co.*, 977 F.2d 906, 910 (4th Cir.1992)); *see also Pryor v. Ready & Pontisakos (In re Vouzianas)*, 259 F.3d 103, 107 (2d Cir. 2001).

Further, the application of our laws in a fashion that provides constitutionally assured *equal protection* of the laws, under the 16th Amendment of the United States Constitution, to all debtors seeking relief in this forum requires that uniform treatment by the courts and comparable elasticity and practicality be part of the court's scrutiny of engagements in large, as well as modest, Chapter 11 cases. Small business debtors, like large complex debtors, deserve the right to access affordable, linear, meaningful bankruptcy relief, to have a reasonable opportunity to advance a Chapter 11 restructuring, and to demonstrate whether the conflicts identified can be resolved, reconciled, or avoided. Access to that opportunity here holds the best prospects for the Restaurant, Ortega, and their creditors.

Even in light of the prospective retention of Attorney Falvey by Ortega individually, the Court is inclined to approve the retention of Attorney Falvey by the Restaurant on an interim basis for thirty (30) days and will entertain a final order of retention at a continued hearing, provided the following can be further demonstrated:

1) Attorney Falvey enters into and files with the Court a satisfactory written retention agreement signed by legal counsel and both debtors, consistent with the Connecticut Rules of Professional Conduct, particularly Rule 1.7, providing, *inter alia*, for:
    a. A waiver of identified potential conflicts, until manifest or actual;
    b. Disclosure of the fiduciary duties of debtor's counsel and each respective debtor;
    c. Disclosure of Attorney Falvey's obligation of disclosure to the Court upon the occurrence of an actual conflict of interest;

d. Disclosure of the potential legal consequences of such disclosure, including, but not limited to:

   i. Disqualification of debtor's counsel and/or disallowance of legal fees and expenses, in whole or in part;

   ii. Resignation of debtor's counsel from one or both engagements;

   iii. Possible dismissal, conversion, the appointment of a trustee, or other liquidation remedy in the Chapter 11 cases; and

   iv. Litigation of related party claims by or between the estates.

e. A waiver of the attorney-client and related work-product privilege, binding upon successors, between the Chapter 11 estates for advice and communications during the period of the joint engagement in the event that actual conflicts or litigation arise between the respective Chapter 11 estates;

f. A statement that a joint or consolidated Chapter 11 plan, which effectively or materially consolidates the assets and liabilities of each estate, may be in the best interests of both Chapter 11 estates and their creditors;

g. Any such other disclosure, admonition, direction, or limitation as Attorney Falvey, the Restaurant, or Ortega deem appropriate; and

h. A statement underscoring the right of each debtor to seek additional separate legal counsel on these bankruptcy matters at any time, and to review the terms of any proposed joint retention agreement.

IV. CONCLUSION

The parties have not made it through the first inning of the ballgame; thus, the Court need not concern itself with the 9th inning, which may never come to fruition. The United States Trustee has raised *bona fide* concerns, but the Court heretofore remains unconvinced that Attorney Falvey's proposed joint representation creates an actual conflict of interest at the present time.[6] As such, Attorney Falvey shall finalize the above-referenced joint retention agreement for further review by the Court and the United States Trustee by its filing with the Court on or before July 3, 2018. In the absence of further objection, an order for retention of Attorney Falvey's firm may enter without further proceedings. In the event of further objection filed within five (5) days of the joint retention agreement's docketing, the Court will schedule a continued hearing to address entry of a final order of retention. Attorney Falvey is also directed to promptly file a retention application in the Ortega case so that any joint retention can be properly scrutinized and coordinated for hearing and prompt disposition.

Nothing in the terms of this proposed retention precludes this Court, the United States Trustee, creditors, or parties-in-interest from revisiting these issues and concerns during the pendency of these Chapter 11 cases as actual conflicts may arise.

Accordingly, the Application is preliminarily approved, subject to prospective re-examination upon compliance with this Court's requirements, as stated herein.

IT IS SO ORDERED in Hartford, Connecticut on this 18th day of June 2018.

James J. Tancredi
United States Bankruptcy Judge
District of Connecticut

[6] If, in the future, there is proof that Attorney Falvey is not a "disinterested person" as defined by the Bankruptcy Code, it may be a basis for the denial of compensation for legal services and expense reimbursement under Section 328(c) of the Bankruptcy Code.

2014 WL 5655025
United States Bankruptcy Court,
S.D. Florida.

In re: Banco Santos, S.A.,
Debtor in Foreign Proceeding.
Vânio Cesar Pickler Aguiar, Trustee, Plaintiff,
v.
Espirito Santo Bank, Defendant.

Case No. 10–47543–BKC–LMI
|
ADV. CASE NO. 13–1934–BKC–LMI
|
Signed October 31, 2014.
|
11/03/2014

Attorneys and Law Firms

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Chapter 15

MEMORANDUM OPINION ON DEFENDANT'S MOTION TO DISQUALIFY

Laurel M. Isicoff, Judge, United States Bankruptcy Court

***1** This matter came before me for evidentiary hearing on March 5th and March 11th, 2014, on Defendant Espirito Santo Bank's Amended Motion for Disqualification of Astigarraga, Davis, Mullins & Grossman, P.A. as counsel for Plaintiff Trustee —Vânio Cesar Pickler Aguiar (ECF # 79) (the "Amended Motion"). After reviewing the Amended Motion and all pleadings filed in connection therewith, and consideration of all of the evidence, case law, statutes, and regulations, I entered an oral ruling on April 21, 2014.[1] This Memorandum Opinion memorializes that oral ruling and includes the factual background that was not necessary to include in the oral ruling.[2]

Summary of Relevant Facts

Overview of Case

Plaintiff Trustee, Vânio Cesar Pickler Aguiar ("Aguiar") was appointed Judicial Administrator of Banco Santos SA. ("Banco Santos") on September 20, 2005 by the 2nd Bankruptcy and Judicial Reorganization Court of Sao Paulo, Brazil (the "Brazil Bankruptcy Proceeding"). Banco Santos was forced into a Brazilian bankruptcy proceeding in 2005 following a series of financial losses, precipitated at least in part by misappropriation of assets by the former head of Banco Santos, Edemar Cid Ferreira, as well as various Banco Santos employees. A criminal case was held in Brazil resulting in Ferreira's conviction for money laundering, among other crimes.

On December 9, 2010, Aguiar filed a Chapter 15 petition for recognition of the Brazil Bankruptcy Proceeding[3] as a foreign main proceeding. I granted the petition for recognition.[4] One of the primary purposes of the Chapter 15 proceeding was to investigate the transfer of Banco Santos assets in and through the United States, to identify potential litigation targets, and, if appropriate, bring actions arising from the results of that investigation. In order to preserve the integrity of the investigative process, and avoid the possible further concealment of misappropriated Banco Santos assets, all discovery was issued under seal and subject to confidentiality requirements. At all times, including with respect to all matters relevant to the Disqualification Motion, Aguiar has been represented by the law firm Astigarraga, Davis, Mullins & Grossman, P.A. ("AD").

One of the financial institutions Aguiar served with discovery requests was Espirito Santo Bank ("ESB"). Just over three years after the Trustee sought Chapter 15 recognition, on December 20, 2013, the Trustee brought this adversary proceeding against ESB. [5] In the complaint, Aguiar asserts that due to wrongful acts of ESB, Banco Santos lost $38.7 million.

Discovery Disputes

***2** The Disqualification Motion arises from the discovery sought by Aguiar prior to his lawsuit against ESB. Initially, Aguiar served ESB with a sealed subpoena in August 2011. For approximately one year, Aguiar dealt directly with ESB and with attorney Robert Stewart of Robert W. Stewart, P.A. During that time, Aguiar requested production of audit confirmation letters issued by ESB in connection with three entities related to Banco Santos. While originally ESB reported that it could not locate the audit letters, it eventually produced them in April 2012. Because of alleged discrepancies in the letters, Aguiar requested an affidavit of a senior vice-president and credit manager at ESB, Margarita Angulo–Levine. Eventually, in September 2012, ESB informed Aguiar that he should proceed with a subpoena for deposition in lieu of preparing an affidavit for Angulo–Levine. ESB then retained the law firm of Tabas, Freedman & Soloff, P.A. [6] ("TF") to represent it in the discovery process.

On November 2, 2012, AD conducted a Rule 2004 examination of Angulo–Levine. During Angulo Levine's examination, after questioning her about certain "back-to-back" loans, [7] AD asked with regard to Banco Santos related transactions whether ESB was "at any point officially criticized by any regulators with regard to these back-to-back loans?" [8] After Angulo–Levine said she did not recall, AD asked whether ESB was "put under a cease and desist or [a memorandum of understanding], or any other form of criticism, by a regulator with regard to any aspect of its business." Angulo–Levine responded that she did not think she could answer the question because she believed the answer was privileged. At this point, there was an off-the-record discussion between Gary Freedman of TF, the partner representing ESB at the 2004 examination, and Edward Davis of AD, the partner representing Aguiar at the 2004 examination, regarding the question. After going back on the record, Angulo–Levine did not respond to the question. Freedman then assured Davis that he would consult with someone, presumably at ESB, who could determine the privileged nature of the question.

Following the Angulo–Levine examination, attorneys at AD and TF had further communication regarding exactly what privilege ESB was asserting. On November 16, 2012, Rodrigo Da Silva of AD asked Freedman in an e-mail, "Have you been able to confer with your client to ascertain whether there is anything privileged ..." Freedman responded that he would check and that he did "not think that testimony was that whatever is confidential necessarily related to back-to-back loans." Da Silva replied, "I agree that it may not be limited to the back-to-back loans. The theme appears to be your client's [Know Your Customer] procedures and there may be a focus on back-to-back loans."

After numerous telephone and e-mail conversations, on November 30, 2012, Freedman sent Davis a letter (the "November 30 Letter") contending that the information sought from Angulo–Levine was protected by "the banking examination privilege, 12 C.F.R. § 309.6 and Florida Statute § 655.057." Moreover, ESB insisted that such information would need to be retrieved directly from a regulator, such as the Florida Office of Financial Regulation (OFR) or the Federal Deposit Insurance Company (FDIC). Finally, the letter concluded:

> ***3** To the extent that you have disagreement with the foregoing [regarding the assertion of the privilege with respect to the MOU question], as we have in the past, we are willing to engage in a telephonic or in person meet and confer. And should Esprito Santo Bank ever be required to testify as to the matters of which you have inquired, we would seek an appropriate confidentiality order.

Later, on December 6, 2012, TF and AD had a conference call regarding the claimed privileges. There is a dispute as to what was agreed during the call. AD insists that no agreement was reached on the December 6 conference call. In a follow up letter Freedman wrote to Davis on December 10, 2012 (the "December 10 Letter"), Freedman referenced an agreement between AD and TF that providing information on ESB loans was not a waiver of rights or privileges. Through a series of statements, Freedman then indicated ESB had not been criticized by state or federal regulators with respect to several transactions related to Banco Santos identified in the letter.

AD also sought to examine Martin Prego, another employee of ESB. However, because the Angulo–Levine exam ran long, the parties decided to postpone Prego's deposition. During the interim, Prego ceased his employment at ESB. AD was informed of his departure during the December 6 conference call. After AD requested Prego's address and contact information so AD could issue a subpoena to Prego directly, on January 2, 2013, along with advising that a response to a subpoena with Prego's contact information would be forthcoming, Freedman wrote, "Please coordinate future depositions with us." In response, Da Silva of AD asked "Do you represent Mr. Prego? If not, what is the basis for your role in coordinating his deposition?" Freedman answered, "I expect that I will be representing him at depo but will be attending either way. Did not think asking you to coordinate it with me would be controversial."

AD ultimately took Prego's 2004 examination on April 3, 2013. Meanwhile, without telling TF, AD conducted another examination and an interview of two former ESB employees. One former employee was Carlos Lloreda, whose 2004 examination was taken on January 23, 2013. Lloreda had not worked for ESB in seven years prior to his 2004 examination. AD did not directly inform TF of this 2004 examination; however, AD filed a notice of taking the Lloreda Rule 2004 examination in the main bankruptcy case on January 11, 2013.[9] Prior to the start of the examination with Lloreda, Davis instructed Lloreda not to disclose anything Lloreda may have discussed at any time with any lawyer including ESB counsel.[10] At the time of the 2004 Examination, Lloreda was not represented by counsel.[11]

In February of 2013, attorneys from AD traveled to Uruguay to interview Alvaro Diez de Medina, another former employee of ESB. Medina had not been employed by ESB for at least seven years prior to his interview. Before interviewing him, AD asked TF via e-mail if Medina was still employed by ESB, to which a TF paralegal responded: "No." Then, a month later, Da Silva of AD contacted Freedman to ask about Medina's employment. While AD asked TF to confirm Medina was no longer an employee of, or had any relationship with ESB, AD never affirmatively advised TF that AD intended to interview Medina. Conversely, no one at TF ever asked anyone at AD why they wanted to know Medina's current relationship with ESB or why AD was seeking to locate Medina. Following the interview with Medina, AD sent a draft affidavit for Medina to review, revise as necessary and to sign; the affidavit was never returned or signed. In November of 2013, TF notified AD that further contact with Medina would need to be through TF as Medina's counsel.

***4** After the examinations and the interview, Aguiar prepared the complaint against ESB. Aguiar provided a copy of the complaint to ESB in October of 2013, in an effort to resolve the dispute before actual litigation. It was at that time, based on certain allegations of the complaint, that ESB and TF learned for the first time that Aguiar and AD had taken the 2004 examination of Lloreda and had interviewed Medina. The parties mediated unsuccessfully on December 13, 2013, and on December 20, 2013 Aguiar filed the complaint.

ESB filed its Motion to Disqualify on January 29, 2014 seeking to disqualify AD from representation of Aguiar based on AD's alleged improper elicitation of privileged material from Lloreda and Medina as well as its ex parte communications with the two former employees, purportedly in violation of the Florida Rules of Professional

Conduct.[12] I set the motion for evidentiary hearing. Subsequently ESB filed the Amended Motion on February 21, 2014 which clarified the privileges it alleges AD violated in its questioning of Lloreda and Medina and supplemented the list of professional rules AD allegedly violated.[13] The Amended Motion also sought relief against Aguiar as Plaintiff, including striking the complaint.

After considering objections filed by Aguiar alleging prejudice caused by the last minute filing of the Amended Motion, I ruled that I would go forward with the Amended Motion but would not consider whether and to what extent those allegations should disqualify Aguiar as Plaintiff. I then conducted a two day trial on the Amended Motion, subject to those limitations.

Summary of Dispute

This dispute involves, at best, an unfortunate breakdown in communication; at worst, a violation of various rules of the Florida Rules of Professional Conduct (the "Rules" and, individually, the "Rule"); and at a minimum, a disappointing lack of professionalism.

The rules involved in this dispute are:

Rule 4–4.2: Communication with Person Represented by Counsel

Rule 4–4.3: Dealing with unrepresented persons

Rule 4–4.4: Respect for Rights of Third Persons

Rule 4–8.4(c): Misconduct

Rule 4–3.4: Fairness to Opposing Party and Counsel

Rule 4–4.1: Truthfulness in Statements to others

The consequences of the relief sought are potentially severe and go beyond ESB's request that AD be disqualified or sanctioned and extends to the adverse impact on the professional status of each of the attorneys accused of misbehavior. Whether there would be professional consequences based on such findings and what would be the severity of those consequences lies with the Florida Bar and the Florida Supreme Court.[14]

In reviewing the alleged violations, I have focused in each instance on the Rule itself as the standard by which AD's actions must be judged for the purpose of determining whether those rules have been violated. As the Preamble to the Rules directs, the Rules are "authoritative," but "[t]he comments are intended only as guides to interpretation ..." FLA. BAR RULES PREAMBLE.

ESB accuses AD of hiding the Lloreda examination and the Medina interview from TF for the purpose of eliciting the information that ESB had asserted during the deposition of Angulo–Levine might be privileged. TF argues that, because AD improperly elicited privileged information from Lloreda and Medina, its client has been harmed in such a way that the only appropriate remedy is to disqualify AD in addition to sanctioning AD for its improper conduct.[15] In order to resolve this, I must first determine whether the information elicited by AD from Lloreda and Medina was privileged. Next, regardless of whether that information was privileged, I must determine if the facts and circumstances surrounding the Lloreda examination and the Medina interview warrant a finding that AD's attorneys violated any of the aforementioned Rules. Finally, if I find that either the information was privileged, or that the Rules were violated, I must also decide whether disqualification or sanctions—or both—are appropriate.

The Testimony and Information Elicited By Astigarraga Davis Does Not Fall Within The Claimed Privileges.

***5** There are three banking privileges asserted by ESB—the common law banking privilege, and privileges arising under 12 CFR § 309.6 and Fl. Stat. § 655.057. There is a dispute regarding which privileges are being relied upon, and even Freedman, in his affidavit, displays confusion regarding whether ESB is relying on the independent common law Banking Examination

Privilege or a common law banking privilege derived from the state and federal laws referenced. For purposes of this ruling I will address all three.

The Privileges

The Banking Examination Privilege is a federal common law privilege. *See In re Subpeona Served Upon the Comptroller of the Currency,* 967 F.2d 630 (D.C.Cir.1992) ("*Fleet* "); *Fed. Hous. Fin. Agency v. JPMorgan Chase & Co.,* 2013 WL 5660247, at *2 (S.D.N.Y. Oct. 16, 2013). This qualified privilege "shields from discovery only agency opinions or recommendations." *Fleet,* 967 F.2d at 635. *See also Raffa v. Wachovia Corp.,* 2003 WL 21517778, at *2 (M.D.Fla. May 15, 2003); *In re Bank One Sec. Litig., First Chicago S'holder Claims,* 209 F.R.D. 418, 426 (N.D.Ill.2002). Because this is a qualified privilege, when a party seeks discovery that would otherwise be subject to the privilege, courts engage in a balancing test, outlined in *Fleet,* to determine whether the otherwise privileged material should be produced. That test is not relevant to the circumstances before me other than to note that the privilege is not absolute.

Although the Eleventh Circuit has not explicitly recognized the common law Banking Examination Privilege, it has recognized the deliberative process privilege. *See Miccosukee Tribe of Indians of Florida v. U.S.,* 516 F.3d 1235 (11th Cir.2008) ("*Miccosukee Tribe* "). "The deliberative process privilege shields from disclosure documents reflecting advisory opinions, recommendations and deliberations comprising part of a process by which governmental decisions and policies are formulated." *Export–Import Bank of the United States v. Asia Pulp & Paper Co., Ltd.,* 232 F.R.D. 103, 108 (S.D.N.Y.2005) (citations omitted). Several courts have recognized that the deliberative process privilege gives rise to the Banking Examination Privilege. *See In re Providian Fin. Corp. Sec. Litig.,* 222 F.R.D. 22, 26 (D.C.Cir.2004); *Raffa,* 2003 WL 21517778, at *2; *In re Bank One Sec. Litig.,* 209 F.R.D. at 426. In *Raffa,* the district court specifically relied on the Eleventh Circuit's recognition of the deliberative process privilege in reviewing the Office of the Comptroller of the Currency's assertion of the Bank Examination Privilege. 2003 WL 21517778, at *2.

As the Eleventh Circuit held in *Miccosukee Tribe,* "[t]he purpose of the deliberative process privilege is to protect the quality of the agency's decision-making process." 516 F.3d at 1263. To determine whether the deliberative process privilege may be applied, the party invoking the privilege is required to demonstrate two things.

> First, the material must be pre-decisional, *i.e.,* "prepared in order to assist an agency decision maker in arriving at his decision." Second, it must be deliberative, "a direct part of the deliberative process in that it makes recommendations or expresses opinions on legal or policy matters."

Id. at 1263 (citations omitted). Moreover, "[e]ven factual material contained in a 'deliberative' document may be withheld pursuant to the privilege where disclosure of the factual material would reveal the deliberative process or where the factual material is so inextricably intertwined with the deliberative material that meaningful segregation is not possible." *Id. See also In re Bank One Sec. Litig.,* 209 F.R.D. at 427; *Raffa,* 2003 WL 21517778 at *2; *accord Fleet,* 967 F.2d at 634.

***6** Section 309.6(a) of Title 12 of the Code of Federal Regulations, an FDIC regulation, dictates that "no person shall disclose or permit the disclosure of any exempt records, or information contained therein." 12 C.F.R. § 309.6(a). Exempt information is defined as: "Records that are contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of the FDIC or any agency responsible for the regulation or supervision of financial institutions." 12 C.F.R. § 309.5(g).

Section 655.057 of the Florida Statutes provides state statutory protections with respect to bank regulator examinations and reports. Section 655.057(1) provides, in part, that "all records and information relating to an investigation by the office are confidential and exempt from the provisions of [Florida's public records law] until such investigation is completed or ceases to be active." Fla. Stat. § 655.057(1). Further, "[a]fter an investigation is completed or ceases to be active, portions of such records relating to the investigation shall be confidential and exempt from [Florida's public records law] to the extent the disclosure would: ... (b) Impair the safety and soundness of the financial institution; ... or (f) Reveal investigative techniques or procedures." *Id.*

Section 655.057(2) states that "reports of examinations, operations, or condition, including working papers, or portions thereof, prepared by, or for the use of, the office or any state or federal agency responsible for the regulation or supervision of financial institutions in this state are confidential and exempt from the provisions of [Florida's public records law]." Fla. Stat. § 655.057(2). Unlike section 655.057(1), section 655.057(2), subject to certain exceptions not relevant to this dispute, shields the internal reports and working papers as confidential even after the conclusion of the investigation. *Id.* These internal reports and working papers are not subject to the otherwise mandatory disclosures under a portion of Florida's "Government in the Sunshine" laws—Fla. Stat. § 119.07(1).

No Privileges Have Been Breached

ESB has the burden to show the statements were privileged. Privilege "is not a favored evidentiary concept in the law since it serves to obscure the truth, and it should be construed as narrowly as is consistent with its purpose." *United States v. Suarez,* 820 F.2d 1158, 1160 (11th Cir.1987). Accordingly, "the party seeking to assert privilege ... has the burden of proving the applicability" thereof, in the absence of which the burden cannot be shifted to the opposing party. *In re Fontainebleau Las Vegas Contract Litig.,* 2011 WL 65760, at *10 (S.D.Fla. Jan. 07, 2011).

AD argues that TF had the obligation to articulate precisely what privilege it was asserting on behalf of ESB and TF's failure to do so disqualifies the assertion of such a privilege. A party asserting a privilege must: "(i) expressly make the claim; and (ii) describe the nature of the withheld documents, communications, or tangible things in a manner that, without revealing information itself privileged or protected, will enable the parties to assess the claim." Fed.R.Civ.P. 45(d)(2)(A). *See also* Fed. R. Bankr.P.2004(c) (requiring subpoena under Bankruptcy Rule 9016, incorporating Rule 45, in order to compel attendance of a non-debtor). Conclusory statements are insufficient to establish the privileged nature of information. *Schreiber v. Society for Sav. Bancorp, Inc.,* 11 F.3d 217, 221 (D.C.Cir.1993) (holding that a conclusory affidavit alone was insufficient to establish privileged nature of bank examination document).

***7** AD correctly argues that the issue of a privilege, although raised at the Angulo–Levine examination, certainly was not confirmed. However, the grounds for asserting privilege were set forth in the November 30 Letter. Nevertheless, the privileges have been asserted only in connection with the question asked of Angulo–Levine, so in determining the context of the asserted privilege in this case, I must start there. [16]

I take pause to note that I, and even TF, used the word elicited—not solicited. There is no dispute what questions were asked of Lloreda, because those are part of a recorded deposition. There is a question what information was asked of Medina in his interview, as there is not a recorded series of questions and answers. Both Da Silva and Davis of AD testified they did not affirmatively ask Medina for any information that ESB argues was privileged and their testimony was not contradicted. In other words, it is not the questions that are at issue, but the answers.

The Banking Examination Privilege, the Florida statutory privilege under section 655.057, and the federal statutory privilege under 12 C.F.R. § 309.6(a), each exist to protect financial institutions and their regulators. However, none is all encompassing. Florida Statute § 655.057(1) is not applicable because there is no dispute that the Florida investigation and associated report were completed. Additionally, Florida Statute § 655.057(2) and 12 CFR § 309.6 do not apply because each applies only to documents and records. The language of the Florida Statutes and the federal regulation each are unambiguous and clear, and I am not at liberty to expand the meaning of an unambiguous Florida Statute, *Daniels v. Fla. Dept of Health,* 898 So.2d 61 (Fla.2005), or an unambiguous federal regulation, *CBS, Inc. v. Primetime 24 Joint Venture,* 245 F.3d 1217 (11th

Cir.2001). Even if the provisions of 12 CFR § 309.6(a) included unwritten (i.e. oral) information, ESB has not proven that any of the information provided by Lloreda or Medina fell within the proscription of 12 CFR § 309.5(g), or if such records even exist. Indeed, it appears ESB took the position that the information that Lloreda and Medina testified or spoke about *was not* contained in any records.

ESB asserts that the common law Banking Examination Privilege extends to the contents of documents subject to the privilege, whether expressed verbally or otherwise. That assertion is unsupported by the law on which ESB relies. Other than citing to discussions of the deliberative or banking examination privilege within particular cases, ESB failed to cite any case that extends these privileges beyond documents. Every case I reviewed in preparing this opinion arose from a request for documents and centered around whether and in what circumstances those requested documents had to be or did not have to be produced. There was one case—*Raffa v. Wachovia Corp.*—where the dispute was the use of an Office of the Comptroller of the Currency document in a complaint, which document had been produced by a third party. I am not willing to make the huge leap that ESB asks me to make—that is, expand the Banking Examination Privilege from documents to oral statements without more support than has been provided.

***8** However, even if the common law Banking Examination Privilege did extend to oral communications, I find that the privilege is not triggered in this circumstance. In each instance, ESB has failed to prove that any of the information provided by Lloreda or Medina was other than factual, and has failed to prove that any of the information was either pre-decisional or deliberative, or so intertwined with a pre-decisional or deliberative record to trigger the privilege.

Thus, ESB has failed to prove that AD or Aguiar obtained or used any privileged information in the investigation leading up to, or in the drafting of, the complaint.

Neither the Lloreda Examination nor the Medina Interview was a Violation of the Florida Bar Rules of Professional Conduct

TF argues that even if the information elicited from Lloreda and Medina was not privileged, the manner in which AD went about the Lloreda examination and the Medina interview, and the failure of AD to provide Lloreda and Medina certain preliminary instructions, all violate several different Florida Bar rules and warrant sanctions, including disqualification.

TF insists that AD was obligated to advise Lloreda and Medina (a) that each of them had the right to counsel, (b) that ESB was represented by counsel, (c) that ESB was providing representation to other former employees of ESB, (d) that ESB was asserting the three privileges, and (e) that ESB did not know that AD was interviewing or examining them (collectively the "Advance Disclosures"). ESB also emphasizes in its pleadings and closing that AD brought documents to the examination and the interview to "refresh the witness' recollection," [17] and with respect to the Medina interview, that Da Silva drafted the affidavit for Medina's review. [18]

I will address the Advance Disclosures and other concerns addressed by TF in the context of the various rules ESB claims were violated.

Rule 4–4.2: Communication with person represented by counsel

Rule 4–4.2 (a) provides:

> In representing a client, a lawyer shall not communicate about the subject of the representation with a person the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the consent of the other lawyer. Notwithstanding the foregoing, an attorney may, without such prior consent,

> communicate with another's client in order to meet the requirements of any court rule, statute or contract requiring notice or service of process directly on an adverse party, in which event the communication shall be strictly restricted to that required by the court rule, statute or contract, and a copy shall be provided to the adverse party's attorney.

***9** FLA. BAR RULE 4–4.2(a).

AD did not violate this Rule. Neither Medina nor Lloreda was represented by counsel at the time AD communicated with them. In fact, as stipulated by the parties, Freedman did not represent either of them until long after either the Lloreda examination or the Medina interview took place. The law in Florida is clear and unambiguous—a former employee of a party is NOT considered the party for purposes of this rule. *HBA Mgmt., Inc. v. Estate of Schwartz,* 693 So.2d 541, 546 (Fla.1997) ("*HBA Management* "). The fact that if either Lloreda or Medina had contacted ESB, ESB might have offered to provide an attorney if they desired one at the time of the examination or interview, does not change this result. [19]

ESB's reliance on *Rentclub, Inc. v. Transamerica Rental Fin. Corp.,* 811 F.Supp. 651 (M.D.Fla.1992) *aff'd,* 43 F.3d 1439 (11th Cir.1995) ("*Rentclub* ") to contradict *HBA Management* is misplaced. *Rentclub* was decided five years before *HBA Management* and the 11th Circuit affirmance predates *HBA Management* by two years, and thus, neither federal court had the benefit of the Florida Supreme Court's ruling on this exact issue. In ruling that a law firm had to be disqualified, the *Rentclub* court reviewed very disturbing facts and held that Rule 4–4.2 "prohibits attorneys from directly communicating with adverse parties, including employees or former employees of the corporate parties represented by counsel." *Id.* at 654. That particular interpretation of Rule 4–4.2 (applied to former employees) was expressly *rejected* in *HBA Management,* 693 So.2d at 545. The interpretation of a Florida Bar rule by a federal court does not survive a different interpretation by the ultimate arbiter of those rules—the Florida Supreme Court.

As the Florida Supreme Court held in *HBA Management* :

> When a corporation or other organization is known to be represented with respect to a particular matter, the bar applies only to communications with those employees who have managerial responsibility, those whose act or omission may be imputed to the organization, and those whose statements may constitute admissions by the organization with respect to the matter in question.

Id. at 545–46.

According to the Florida Supreme Court, when contacting former employees there are only two restrictions counsel must consider—not intruding on the attorney client privilege [20] and proceeding in accordance with Rule 4–4.3 if the former employee is otherwise unrepresented, which rule I will address next.

***10** Moreover, while ESB repeatedly accuses AD of failing to provide the Advance Disclosures, such a failure is not relevant to determining whether *this* Rule was violated. That argument, to the extent it is supported by law, is relevant to whether AD violated Rule 4–4.3 and the other Rules I will address.

Rule 4–4.3: Dealing with unrepresented persons

> (a) In dealing on behalf of a client with a person who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer

> knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding. The lawyer shall not give legal advice to an unrepresented person, other than the advice to secure counsel.

FLA. BAR RULE 4–4.3(a).

The Rule warns "a lawyer shall not state or imply that the lawyer is disinterested." *Id.* While AD did not inform Lloreda or Medina that its representation was adverse to ESB, AD did not say it was disinterested. Consistent with what Davis told Freedman, Davis told Medina and Lloreda that AD would "go where the evidence takes them." In fact, ESB has not shown that at the time of either the Medina interview or the Lloreda examination that Aguiar had or had not made any final determination requesting any cause of action against ESB. Indeed, Davis' testimony suggests the contrary.

The comment to Rule 4–4.3 explains that to avoid a misunderstanding, a lawyer may need to "explain that the [lawyer's] client has interests opposed to those of the unrepresented person." FLA. BAR RULE 4–4.3 cmt. At no time were Aguiar's interests adverse to either witness, and even if Aguiar's interests were adverse to ESB, nothing in this Rule required AD to disclose that information.

ESB argues that AD had an obligation to give Lloreda and Medina the Advance Disclosures. [21] But AD's failure to give either Lloreda or Medina the Advance Disclosures did not violate Rule 4–4.3. ESB insists the privileges it asserted are so sacrosanct that these privileges rise to the same level as the attorney client privilege and therefore, as with the attorney-client privilege, cautionary warnings were required before the examination and interview. ESB has failed to provide support for this argument. All the authorities ESB cited are cases dealing with the attorney-client privilege and ESB has provided no persuasive argument why the banking privileges, statutory, regulatory or common law, should rise to the same level as the attorney-client privilege. Moreover, those privileges are not ESB's to assert, but only to protect, as I will soon address in more detail.

ESB also failed to cite to any authority to support its argument that AD had an obligation to advise either Lloreda or Medina that he should get an attorney. Interestingly, ESB does not cite the portion of this Rule that warns "the lawyer shall not give legal advice to an unrepresented person, other than the advice to secure counsel." FLA. BAR RULE 4–4.3(a). Does this mean, as ESB argues, that AD had an affirmative obligation to tell either Lloreda or Medina to get a lawyer? The comments do not address this at all; rather, the comments suggest that Rule 4–4.3(a) is an exception to the absolute proscription that the lawyer cannot advise the unrepresented person at all when dealing with the unrepresented person.

***11** Rule 4–4.3 is an adoption of the ABA Model Rule and has been adopted in many other states. *See* MODEL RULES OF PROF'L CONDUCT R. 4.3. There are hundreds of cases around the country that discuss this Rule. Presumably if any court interpreted this Rule as an affirmative obligation to advise an unrepresented person of his or her right to counsel, ESB would have brought such a case to my attention. Moreover, my review of several cases failed to uncover any court that addressed this portion of the Rule, let alone held that such an obligation exists. *See, e.g., Suck v. Sullivan,* 1999 WL 33437564, at *2 (Mich.Ct.App. Aug. 27, 1999) ("MRPC 4.3 does not impose a duty on an attorney to recommend that a person who is not represented by counsel confer with an attorney under any circumstances.") AD correctly points out, this is not a criminal proceeding and AD is not the government. ESB has not cited to any authority—because none exists—that AD had any obligation whatsoever to advise Lloreda or Medina as it suggests.

Not only did AD have no obligation to advise either Lloreda or Medina that either had the right to an attorney, AD had no obligation to advise either of them that ESB had retained an attorney or had provided an attorney for a former employee who had recently left ESB. Lloreda and Medina were perfectly capable of contacting ESB about the examination or interview if either had chosen to do so. Moreover, both Lloreda and

Medina knew that AD had taken the deposition of Angulo–Levine; thus they knew that ESB had been questioned. Whether Lloreda or Medina might think Angulo–Levine appeared at a deposition without an attorney is not something I can glean from the evidence. But, I presume Lloreda and Medina are sophisticated enough to assume an attorney was present on Angulo–Levine's behalf. Furthermore, there was no basis for anyone to suppose that ESB's willingness to represent an employee who had recently been terminated would translate into a willingness to provide legal counsel to two people who had not been employed by ESB for at least seven years. Finally, it is clear from the record that AD made every effort, through TF, to determine whether Medina had any continuing relationship with ESB before contacting him directly, inquiring as to Medina's whereabouts and status on at least three separate occasions.

Rule 4–4.4: Respect for Rights of Third Persons

> (a) In representing a client, a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person or knowingly use methods of obtaining evidence that violate the legal rights of such a person.
>
> > (b) A lawyer who receives a document relating to the representation of the lawyer's client and knows or reasonably should know that the document was inadvertently sent shall promptly notify the sender.
>
> FLA. BAR RULE 4–4.4(a) & (b).

ESB argues that AD violated this Rule because AD failed to advise either Lloreda or Medina of the Advance Disclosures.

I can quickly dispense with Rule 4–4.4(b). This Rule clearly does not apply because no document was ever requested or ever produced. Nonetheless, ESB argues this Rule applies because the comments to the Rule note that its purpose is to prevent one side from gaining an unfair advantage over another. The issue of unfair advantage is one I will address, but since there is no document involved in this dispute, Rule 4–4.4(b) clearly does not apply and AD did not violate it.

I now turn to Rule 4–4.4(a). The third parties whose rights were violated, according to ESB, were ESB, the FDIC and the OFR, because AD "improperly intruded into privileged relationships, relationships of which ESB was a direct beneficiary." [22] I ruled above that the Advance Disclosures were not information that AD was legally, ethically or morally obligated to provide to either Lloreda or Medina. Thus AD's failure to advise Lloreda and Medina does not violate this Rule. Moreover, the banking privileges invoke no different consideration. ESB correctly acknowledges that the banking privileges belong to the regulators. *See In re BankOne Sec. Litig.,* 209 F.R.D. 416, *Raffa,* 2003 WL 21517778, at *2. However, nothing in the statute, regulations or case law suggests that the relationship between bank and regulator is a privileged relationship that overrides or supersedes the Florida statutory limitations, the federal regulatory limitations, or the qualified common law privilege. The obligation ESB says it owes to the regulators arising from its relationship to the regulators is to protect the asserted privileges on behalf of those entities. ESB has done so by raising the possible privilege issue at the Angulo–Levine deposition and by advising AD that, should AD ask ESB to testify regarding these matters, ESB would seek a confidentiality order. ESB concedes that it is not bound by the statements made by Lloreda and Medina.

***12** I ruled above that the privileges held by the regulators relate to documents and at no time did AD ask for documents or receive documents from either Lloreda or Medina. No legal rights were compromised, nor were relationships interfered with. Thus, ESB has failed to demonstrate that AD has violated Rule 4–4.4(a).

4–8.4(c): Misconduct

A lawyer shall not ...

> (c) engage in conduct involving dishonesty, fraud,

> deceit, or misrepresentation, ...

FLA. BAR RULE 4–4.8(c).

ESB asserts that AD violated this Rule by conducting "secret" discovery, and doing so after TF requested that future depositions be conducted through Freedman. ESB also argues that AD's failure to give Lloreda and Medina the Advance Disclosures violated this Rule as well. I have already explained why AD was not obligated to make any of the Advance Disclosures to Lloreda and Medina, and therefore, AD's failure to do so did not violate this Rule.

AD did not engage in "secret" discovery, although it is clear there was a disconnect between AD and TF. It is unclear whether this apparent misunderstanding could have been resolved by communicating directly rather than by e-mail, but that is of no moment here. AD did not hide the fact that it was taking Lloreda's examination, nor did AD hide the fact that it was looking for Medina. With respect to Medina, AD made two things clear to TF. One, that AD was trying to find Medina, and two, that AD wanted to confirm whether or not Medina was still an employee of ESB. There is no evidence, and it was not argued by ESB, that TF ever asked AD *why* the firm was looking for Medina or *why* AD wanted to know Medina's current employment status with ESB. Presumably, if AD contacting Medina was of any concern to ESB, someone at TF would have inquired further.

While AD did put the Lloreda 2004 examination on the main case docket, it did not need to do so. Thus, whether TF filed a notice of appearance in the main case is not of any consequence. No local rule or rule of civil procedure required AD to tell ESB that it was taking the depositions of, or interviewing, former employees. Indeed, as the Florida Supreme Court in *HBA Management* held, this is the case even if the former employees from whom discovery is sought are the very actors whose actions gave rise to the claims for which the discovery is sought.

> That former employees may have engaged in 'action or inactions' while they were employed that may give rise to liability of the employer is simply a matter of historical fact ... [T]here is no valid reason to distinguish between former employees who witnessed an event and those whose act or omission caused the event.

HBA Management, 693 So.2d at 546 (citations omitted)

However, there is the issue of the email exchange in which one email from Freedman stated that all future depositions should be coordinated through him. As detailed above, this request appeared in the middle of an email discussion addressing AD's attempts to schedule former employee Prego's deposition. In reviewing the email chain the request certainly appears to be a request limited to coordination of any future depositions of Prego, not a broad sweeping request as is now argued in hindsight. While the first email in the chain includes a request for information regarding Medina's whereabouts and the status of his current relationship with ESB, as well as Prego's contact information, all the subsequent emails in this chain relate to Prego's deposition; there was no further mention of Medina by anyone at TF. It is possible, as Freedman now claims, he meant that *all* depositions AD took which related to ESB were to be coordinated through him. It is also reasonable that AD did not understand that to be the case because that statement—even in context—says no such thing.

***13** Even if Freedman's statement was intended to include all depositions, AD's failure to understand such intent is clearly excusable and does not reflect any dishonesty, fraud, deceit or misrepresentation. On the other hand, if Freedman thought he meant all depositions relating in any way to ESB, it is reasonable that he would have assumed that, if AD had an objection to coordination of future depositions, AD would have said something. This is especially likely considering AD asked before why TF wanted to be involved in the examination of former employee, Prego. This was, at worst, a legitimate miscommunication between the parties, and it does not give rise to a Rule violation.

ESB also has not proven there was any other agreement in place that AD violated such that this Rule would be implicated. The November 30 Letter does not reflect any agreement regarding discovery. The statement in the letter that "should Esprito Santo Bank ever be required to testify as to the matters of which you have inquired, we would seek an appropriate confidentiality order," can only reasonably be interpreted to mean, especially in light of the events that preceded the letter, that if AD tried to re-set ESB's deposition, or question ESB regarding the questions that Angulo–Levine declined to answer at her examination, then ESB would seek a confidentiality order, not a protective order. There is nothing in the sentence, or in the entire letter, as ESB argues, to suggest that AD was going to avoid taking any discovery relating to ESB and the "back-to-back" loan transactions about which Angulo–Levine was questioned and testified, without first going to court and getting a ruling on the privilege issue that had been asserted by ESB. Indeed, this underscores Davis' testimony that every discussion on this issue focused on relevancy and confidentiality rather than privilege.

Finally, the parties dispute that any agreement was reached during the phone conversation of December 6, 2012. Davis testified that no agreement was reached except that all parties reserved all of their rights with respect to the asserted privilege. Freedman testified he understood that the agreement was "I would provide them a writing expressing that (1) nothing in the writing shall be deemed a waiver of any rights, privileges or objections that ESB may have in respect to their inquiry; and (2) that ESB had never been criticized by any regulator with respect to the Banco Santos related depository accounts or loan relationships. The only caveat to the resolution was that the Banco Santos' Trustee would reserve his right to contest ESB's assertion of the privilege and objections raised in the November 30, 2012 letter." I accept that both attorneys are being truthful regarding what they believe and recall was the result of that conversation. Still, the evidence shows a misunderstanding between the parties as to how to proceed, but not an agreement regarding any third party discovery. A misunderstanding does not satisfy ESB's burden to show that AD was fraudulent, deceitful, or misrepresented anything.

The fact that all of this was taking place while Prego's deposition was being coordinated does show that it would have been professional and appropriate to mention these interviews and depositions, especially in light of Davis' statement regarding transparency. That being said, AD's decision not to do so did not violate this Rule. ESB's speculation that AD purposely delayed the Prego deposition is (a) only speculation, (b) unsupported by the evidence that shows that all parties had scheduling issues that caused the delay, and (c) irrelevant to the issue before me.

Rule 4–3.4: Fairness to Opposing Party and Counsel

***14** A lawyer shall not:

> (c) knowingly disobey an obligation under the rules of a tribunal except for an open refusal based on an assertion that no valid obligation exists;
>
> (d) in pretrial procedure, make a frivolous discovery request or intentionally fail to comply with a legal proper discovery request by an opposing party; ...

FLA. BAR RULE 4–3.4(c) & (d).

This Rule does not apply to the allegations of this dispute. ESB argues that the "secretive discovery efforts" and asking questions, the response to which included information ESB asserts is privileged (and therefore required a prior determination by the court), violate this Rule. I have already addressed each of these arguments in this opinion.

ESB accuses AD of misleading TF "into believing that if it chose to seek the Privileged information, that it would seek a Court ruling before launching into those areas." There is absolutely no evidence to support this allegation. AD has not "admitted" it violated this Rule; AD simply acknowledges that the ultimate determination of the privilege is by the court. But that issue was not in a procedural posture for court review. As I already noted, the November

30 Letter did not in any way suggest that AD could not ask anyone else questions relating to ESB, the "back-to-back" loans, or examinations. Nor did the December 6 phone conversation, or the December 10 Letter, in any way implicate the necessity of the court's involvement in the Aguiar's investigation except as to specific questions asked of ESB and only subject to a confidentiality order.

Moreover, ESB has not argued that AD solicited this testimony. In other words, AD did not ask impermissible questions, rather, it received allegedly privileged responses. So even if ESB had been present at the Lloreda examination, or the Medina interview, there is no basis to believe ESB would have objected to the questions, as they were asked, that gave rise to the problematic responses, because the questions were not directed to elicit this testimony. The problematic answers would not have been "stricken" at the deposition or the interview, although ESB might have asked that the Lloreda transcript be sealed (as it has here). Procedurally, what would have occurred is, if Aguiar had tried to use those responses at trial, ESB could have objected and then the court would have ruled on the privilege issue. AD did not "delve into matters previously asserted as privileged" because the few questions AD asked that were related to this testimony are similar to responses provided without objection by Angulo–Levine and Prego in their respective examinations.

ESB argues, however, that AD had an affirmative duty to instruct both Lloreda and Medina *not* to disclose any information that ESB had asserted was privileged and therefore these answers would never have been elicited. I have already addressed and rejected this argument.

Rule 4–4.1: Truthfulness in statements to others

In the course of representing a client a lawyer shall not knowingly:

> ***15** (a) make a false statement of material fact or law to a third person;

FLA. BAR RULE 4–4.1.

The comment to this Rule provides:

> A lawyer is required to be truthful when dealing with others on a client's behalf, but generally has no affirmative duty to inform an opposing party of relevant facts. A misrepresentation can occur if the lawyer incorporates or affirms a statement of another person that the lawyer knows is false. Misrepresentations can also occur by partially true but misleading statements or omissions that are the equivalent of affirmative false statements.

Id. cmt.

ESB argues that AD "completely misled Lloreda and Medina" because, in addition to failing to give the Advance Disclosures, AD did not advise either Lloreda or Medina that Aguiar was adverse to ESB at the time of the examination and interview. I have already dealt with the Advance Disclosures and an affirmative obligation to disclose the alleged adverse position, so I will focus on whether AD deliberately misled Lloreda or Medina as to whether the Aguiar was adverse to ESB at the time each was examined or interviewed.

There is no evidence that, at the time of the Lloreda Examination or the Medina interview, the Aguiar was, in fact, adverse to ESB. There is no question that ESB was being investigated. Indeed, Lloreda asked during his examination if Aguiar intended to sue ESB. Consistent with what Davis told Freedman during the Angulo–Levine deposition in response to Freedman's question whether ESB was a litigation target, Davis said they would go where the evidence led them. Da Silva does not recall if either he or Davis told Medina that Aguiar was investigating ESB, although he argues a possible lawsuit is included in the "assets" Da Silva told Medina AD was investigating. Thus, ESB has failed to prove there was any misrepresentation.

Should Astigarraga Davis Be Disqualified or Sanctioned?

Disqualification

A party moving to disqualify counsel bears a heavy burden to demonstrate appropriate grounds for such relief. *See In re BellSouth Corp.,* 334 F.3d 941, 961 (11th Cir.2003) (internal citations omitted) ("The party moving to disqualify counsel bears the burden of proving the grounds for disqualification."), *Evans v. Artek Sys. Corp.,* 715 F.2d 788, 794 (2nd Cir.1983) (noting that a movant's task in seeking removal of opposing counsel is a "heavy burden"). Further, in cases where disqualification of an attorney is based on an alleged ethical violation, "the court may not simply rely on a general inherent power to admit and suspend attorneys, without any limit on such power." *Schlumberger Technologies, Inc. v. Wiley,* 113 F.3d 1553, 1561 (11th Cir.1997). As such, courts will not "deprive an attorney of the opportunity to practice his profession on the basis of a determination after the fact that conduct is unethical if responsible attorneys would differ in appraising the propriety of the conduct." *Id.* (internal citations and quotations omitted). Indeed, "[d]isqualification is a harsh sanction, often working substantial hardship on the client," and "disqualification should [accordingly] be resorted to sparingly ..." *Norton v. Tallahassee Mem'l Hosp.,* 689 F.2d 938, 941, n.4 (11th Cir.1982).

***16** Furthermore, when the basis for disqualification is improper disclosure or receipt of privileged information, the party moving for disqualification must demonstrate both the existence of a privilege and an informational advantage obtained by the party against whom disqualification is sought. *See, e.g., Moriber v. Dreiling,* 95 So.3d 449, 454 (Fla.3d D.C.A.2012) ("The receipt of an inadvertent disclosure warrants disqualification when the movant establishes that: (1) the inadvertently disclosed information is protected, either by privilege or confidentiality; and (2) there is a 'possibility' that the receiving party has obtained an 'unfair' 'informational advantage' as a result of the inadvertent disclosure"); *Miccosukee Tribe of Indians v. Lehtinen,* 114 So.3d 329, 332 (Fla.3d D.C.A.2013) (noting that disqualification of counsel cannot rest on mere speculation that an informational advantage *may have* been gained in the context of case in which counsel had previously represented the opposing party).

I have already held that the information obtained by ESB was not privileged. I have also held that AD did not violate any of the Florida Rules of Professional Responsibility. These determinations should end the inquiry into whether AD should be disqualified. *See Moriber,* 95 So.3d at 454 (finding the privilege and information advantage elements for disqualification are necessarily interrelated "because only the inadvertent disclosure of privileged or confidential information can yield an 'unfair' 'informational advantage.' ").

Moreover, even if the information obtained was privileged in some respect, it did not create an unfair advantage such that disqualification is appropriate. *See, id.* ("[T]he fact that the inadvertently disclosed information is privileged or confidential, standing alone, does not automatically warrant disqualification."). AD correctly argues that even if ESB had shown some sort of privilege existed in the information obtained from Lloreda and Medina, none of it is admissible as evidence against ESB as it is hearsay under FRE 801(c) and not former testimony under FRE 804(b)(1). *U.S. v. Walthour,* 202 Fed. Appx. 367, 371 (11th Cir.2006) (testimony about the contents of a police report is inadmissible hearsay). Additionally, to the extent Lloreda or Medina revealed information contained in an audit, the rules of evidence would preclude that testimony; Aguiar would need to seek admission of the audit (assuming it had been obtained). If Aguiar sought to obtain the audit, then, to the extent the applicable regulator objected, the adjudicating court would need to review the request in light of the balancing test the qualified privilege invokes in such a circumstance. If the audit was discoverable, it would probably be admissible if it was relevant. But the examination and the interview have no relevancy to the process I have just described, and therefore, Aguiar has not gained any "unfair" informational or tactical advantage. The fact that Aguiar has obtained information that ESB would prefer Aguiar not have is not the type of tactical advantage the rules are designed to insulate.

As AD noted in its closing, ESB repeatedly claimed that the audits about which Lloreda and Medina allegedly provided information are irrelevant to Aguiar in this case because they do not discuss the "back-to-back" loans at issue. If that is true, then none of the "privileges" were implicated because, at best, those privileges, if applicable to oral statements, only apply to information contained in the audits.

ESB has failed to prove that AD violated any of the Florida Rules of Professional Responsibility. ESB has also failed to prove that AD obtained an unfair advantage in litigation by interviewing Medina and taking the examination of Lloreda, such that the only way to purge the information AD obtained is to disqualify AD. As I addressed in this opinion, AD did not affirmatively seek the information that ESB asserts is privileged. Moreover, ESB has failed to prove that the fact of an examination, its purpose and its results, as opposed to the records of that examination, is covered by any of the privileges it asserts. Consequently, the information AD obtained was not privileged and it has no unfair advantage.

***17** This does not mean that AD's conduct was a benchmark of professionalism. This case underscores an ethical tightrope on which attorneys occasionally find themselves. In this profession, attorneys must zealously represent their clients, while staying within the ethical boundaries proscribed by the applicable rules of professional conduct. Nothing AD did violated the Rules, nor was there any agreement between the parties that required AD to act any differently than it did. Nonetheless, while Davis longs for a transparent process, it appears that he views transparency in a very different light than I would. AD complains that ESB was not forthcoming in its discovery responses, presumably to explain why AD did not volunteer all aspects of its investigation to ESB and TF. However, I do not find any of this relevant to the issue I have had to decide. As is often said in a variety of contexts—"two wrongs do not make a right."

Sanctions

ESB argues that AD's behavior was so outrageous, so violative of so many Florida Bar Rules of Professional Responsibility, that this Court should sanction AD under its inherent sanction powers. The court's ability to issue sanctions has been framed by the Supreme Court in *Chambers v. Nasco, Inc.,* 501 U.S. 32 (1991). In that case, the Supreme Court reemphasized that federal courts have the inherent power to sanction in addition to those powers to sanction provided by, and framed by, various rules of procedure and statutes.

The *Nasco* court wrote that it had "long been understood that certain implied powers must necessarily result to our Courts of justice from the nature of their institution ..." *Id.* at 43 (internal quotations omitted) (citations omitted). The Court observed that federal courts are "vested" with power to "impose silence, respect, and decorum, in their presence, and submission to their lawful mandates." *Id.* Finally the Court explained that these powers are necessarily vested so courts may "manage their own affairs so as to achieve the orderly and expeditious disposition of cases." *Id.* (citations and quotations omitted).

However, as the Eleventh Circuit observed in *Peer v. Lewis,* 606 F.3d 1306, 1314 (11th Cir.2010), the Supreme Court admonished that this inherent power "is both broader and narrower than other means of imposing sanctions." Further, "the inherent power's bad faith standard narrows the range of conduct that can satisfy this higher threshold for sanctions." *Id.* at 1314–15. *See also Byrne v. Nezhat,* 261 F.3d 1075, 1121 (11th Cir.2001) ("[A] finding of bad faith is the key to unlocking the inherent power ...").

Thus, while I find some of AD's choices disappointing, they are not sanctionable. To the extent that, notwithstanding the parameters for sanctions, I might be inclined to hold someone "responsible" for this entire sideshow, I hold both sides equally responsible, and each of AD and TF, by having to incur what I assume are substantial costs associated with this dispute, have been sanctioned enough. How these law firms will allocate these expenses between themselves and their respective clients is not something with which I choose to be, or need to be, involved.

Conclusion

As I observed when this trial began, Chesterfield Smith once reminded us "[t]he dominant question for tomorrow's lawyers and their clients should be: Is it right? Not: Is it legal?" This is echoed in the preamble to the Rules of Professional Conduct "The rules do not, however, exhaust the moral and ethical consideration that should inform a lawyer ..." FLA. BAR RULES PREAMBLE.

This unfortunate episode is a result of miscommunications, misunderstandings, and miscalculations. Thus, while Freedman might have expected to be consulted about any discovery relating to his client, that is not what he communicated to AD. And, while AD might or might not have believed that Freedman expected to be consulted, I do not find that anything in the evidence presented to me amounted to an affirmative undertaking to do so. A great deal about which ESB takes exception appears to have crystallized in hindsight. Moreover, much of ESB's righteous indignation is exaggerated. Nonetheless, while I find that AD did not violate any of the Rules of Professional Conduct of the Florida Bar, and while I further hold that the information gathered by AD does not warrant disqualification of the firm or sanctions, I do find that AD could have done better. In light of Davis' comment to Freedman that the process would be transparent, it should have been, and it was not.

***18** Accordingly, the Defendant's motion is DENIED.

All Citations

Not Reported in B.R., 2014 WL 5655025, 25 Fla. L. Weekly Fed. B 163

Footnotes

1 The Oral Ruling appears at ECF # 164.

2 The following are my findings of fact and conclusions of law pursuant to Rule 7052 of the Federal Rules of Bankruptcy Procedure. To the extent it is determined that I did not have jurisdiction to finally resolve this dispute, the following constitute my proposed findings of fact and conclusions of law pursuant to 28 U.S.C. § 157(c)(1). However, no party has challenged my jurisdiction to enter a final order on this matter.

3 Case No. 10–47543–BKC–LMI, ECF # 1.

4 Case No. 10–47543–BKC–LMI, ECF # 9.

5 Defendant ESB is a subsidiary of the Portuguese bank, Banco Espirito Santo.

6 At the time hired by ESB, the firm's name was Tabas, Freedman, Soloff, Miller, & Brown.

7 "Back-to-back" loans are loans in which two parties, in different countries, lend money to each other. One purpose for these loans is to hedge against currency fluctuation. Normally, there is a fixed term for repayment of around a year. For example, one company might be in Brazil and another in the U.S. The Brazilian company would lend Brazilian reals for the same value of U.S. Dollars from the U.S. company. A year later, there would be repayment. *Definition of* '*Back–to–Back Loan* ', INVESTOPEDIA, *http:// www.investopedia.com/terms/b/backtobackloan.asp* (last visited October 27, 2014).

8 One of Aguiar's contentions in his complaint against ESB is that "back-to-back" loans were utilized to fraudulently siphon funds from Banco Santos.

9 Case No. 10–47543–BKC–LMI, ECF # 28.

10 By Davis: Let me give you some basic ground rules as to how this process works. Let me say first one caution. To the extent you ever have information in response to any of my questions that you learned from a lawyer that is representing Espirito Santo Bank or any of your other employers or your own lawyer, do not tell me that.

By Lloreda: Okay.

11 TF began to represent Lloreda in February of 2014, long after the Rule 2004 examination.

12 ECF # 24.

13 ECF # 79.

14 The Florida Bar enforces the Rules but the ultimate decision maker on any sanctions arising from violations of those Rules is the Florida Supreme Court.

15 And, as already noted, in the Amended Motion, TF argues the "taint" extends to the Plaintiff, Aguiar, himself. That issue will be addressed by separate order.

16 I have also considered the email exchange regarding "back-to-back" loans and "know your customer" procedures, as general and undifferentiated as any such privilege was expressed therein, into consideration in my ruling.

17 TF has not explained how using a document to refresh a witness' recollection is problematic other than such practice might possibly be used to compromise testimony at trial.

18 TF argues that evidence of AD's wrongdoing is that Da Silva actually drafted the affidavit, although he made clear in his email correspondence with Medina that the affidavit was subject to any revisions, corrections, or deletions Medina might wish to make, and also, that in a few instances Da Silva included questions for Medina in the draft affidavit and email, including a question asking Medina to clarify to which regulator(s) (Florida or federal) Medina had referred in his interview. However, all of these complained about actions are consistent with the way that witness interviews are generally conducted, and thus I will not address these complaints again.

19 In support of the motion, TF provided an affidavit from Lloreda (who also testified at trial), in which Lloreda stated that he would have contacted ESB and accepted such representation from ESB had AD informed him that the other former employees were being provided representation. While noted, this testimony is not relevant to the issue before me.

20 There is no dispute that Davis gave a clear instruction to Lloreda regarding the attorney client privilege and Davis testified, without contradiction, that he always advises persons whom he is deposing or interviewing about the attorney/client privilege. Presumably, Davis gave the same cautions to Medina. There was certainly no evidence that he did not.

21 There is no evidence that ESB provided counsel to more than one former employee—Prego.

22 This argument stems from the comment to Rule 4–4.4 which explains that rights of third persons "include legal restrictions on methods of obtaining evidence from third persons and unwarranted intrusions into privileged relationships, such as the client-lawyer relationship." FLA. BAR RULE 4–4.4, cmt.

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Getting Paid and Avoiding Disgorgement: Who Pays the Freight in a Section 363 Sale?

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Introduction

It is an unfortunate reality in today's chapter 11 bankruptcy practice that many chapter 11 cases become, at some point, administratively insolvent. Bankruptcy professionals are in the business of solving problems. But what happens when the primary problem that needs to be solved in order for a chapter 11 case to be declared a success becomes: How are the expenses of administering the case going to be paid? In a case where the goal is to sell substantially all of the debtor's assets under section 363 of title 11 of the United States Code (the "Bankruptcy Code"), should bankruptcy court approval of the sale be conditioned on sufficient funds remaining in the estate post-closing to ensure that all administrative expenses receive payment in full? If so, who should be responsible for paying such amounts?

Today's Chapter 11

Chapter 11 practice has changed in recent years. The chapter 11 process that most of us studied in law school, where a company takes advantage of an automatic stay to buy time for it to negotiate with its secured lender and its unsecured creditors and, ultimately, confirm a plan of reorganization under section 1129 of the Bankruptcy Code has, in large part, been supplanted by section 363 sales, which are usually followed by either confirmation of a liquidating plan, conversion to chapter 7 or a structured dismissal. This is particularly true in middle market bankruptcy cases, where the debtor's capital structure often cannot support the expense associated with a protracted chapter 11 reorganization process. While this trend is often criticized,[1] the number of "successful" bankruptcies (including, close to home, General Motors and Chrysler) that have resulted from section 363 sales should not be discounted.[2]

One reason that chapter 11 has changed in this manner is that the lending industry has changed. Today's distressed businesses have substantial access to capital, including asset based financing and mezzanine or second lien financing.[3] Due to the rise of second (or even third) lien debt in particular, companies can often obtain "secured" financing equal to the estimated going concern value of the company itself. Faced with the availability of relatively cheap money and

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[1] Commentators have bemoaned:

> Corporate reorganizations have all but disappeared. Giant corporations make headlines when they file for Chapter 11, but they are no longer using it to rescue a firm from imminent failure. Many use Chapter 11 merely to sell their assets and divide up the proceeds.

See Douglas G. Baird & Robert K. Rasumussen, *The End of Bankruptcy*, 55 Stan. L. Rev. 751, 751 (2002).

> The concept of debtor reorganization and rehabilitation is in peril. The marvel of modern reorganizations of financially distressed businesses that was ignited by the railroad equity receiverships of the nineteenth century and codified by twentieth-century legislation is fading. As the twenty-first century progresses, the use of Chapter 11 of the Bankruptcy Code as a primary reorganization and rehabilitation tool for businesses is under relentless attack—an attack led by those who want to revert back to strict enforcement of contracts and the primacy of creditor rights. Fundamental changes in the economy, accompanied by a shifting and more conservative intellectual approach, are now leading to cries that Chapter 11 is obsolete and irrelevant in a modern economy.

See Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. Rev. 129, 129 (2005).

[2] *See* Jared A. Wilkerson, *Defending the Current State of Section 363 Sales*, 86 Am. Bankr. L.J. 591 (2012) (refuting criticism of section 363 sales in chapter 11 and highlighting potential efficiencies of such sales).

[3] One commentator recently stated that junior secured debt issuances "rose from virtually zero in 2000 to a peak of $30 billion in 2007." *See* Athanas, Warren & Khatchatourian, *Bankruptcy Needs to Get Its Priorities Straight: A Proposal for Limiting the Leverage of Unsecured Creditors' Committees When Unsecured Creditors are "Out-Of-The-Money,"* 26 Am. Bankr. Inst. L. Rev. 93, 102-03 (2018).

the understandable resistance by management to commencing a bankruptcy case, distressed businesses typically do not seek relief under chapter 11 until all other avenues have been exhausted. By the time a bankruptcy petition is filed, therefore, all of the debtors' assets are usually encumbered by the liens of one or more lenders. The total amount of the secured loans (likely broken down into at least two tranches of priority) exceeds the enterprise value of the debtor.

Another reason for the shift to section 363 sales is the fact that the bankruptcy reorganization process has become increasingly expensive. Few middle market debtors can afford the expense associated with a traditional chapter 11. This is because bankruptcy introduces costs into a debtor's already stretched budget that do not exist outside of bankruptcy. For example, in addition to paying its own professionals, debtors are responsible for paying various fees to the bankruptcy court and to the Office of the United States Trustee and, more significant yet, the fees and expenses of bankruptcy professionals that are retained by any statutory committees, examiners and trustees.[4]

These costs become administrative expenses under section 503 of the Bankruptcy Code and must generally be paid in full on or before the effective date of any confirmed plan.[5]

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[4] Section 330 of the Bankruptcy Code provides for compensation of all professionals whose retention is approved by the court. Specifically, section 330(a) provides, in relevant part:

> [T]he court may award to a trustee, a consumer privacy ombudsman appointed under section 332, an examiner, an ombudsman appointed under section 333, or a professional person employed under section 327 or 1103
>
> > (A) reasonable compensation for actual, necessary services rendered by the trustee, examiner, ombudsman, professional person, or attorney and by any paraprofessional person employed by any such person; and
> >
> > (B) reimbursement for actual, necessary expenses.

11 U.S.C. § 330(a). A 2007 study of professionals' fees in bankruptcy suggested that "[c]ommittee professionals cost the estate about two-fifths of what the debtor's professionals cost." Jesse Greenspan, *Time Spent In Chapter 11 Doesn't Affect Costs: Study*, Law 360 (Dec. 7, 2007), http://www.law360.com/articles/41896/time-spent-in-chapter-11-doesnt-affect-costs-study.

[5] Section 1129(a)(9)(A) of the Bankruptcy Code provides: "Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that – with respect to a

Amplifying the administrative expense problem in many cases is section 503(b)(9) of the Bankruptcy Code which, generally speaking, grants administrative expense priority for "the value of any goods received by the debtor within 20 days before the date of commencement of a case."[6] This section, which was added to the Bankruptcy Code in 2005, elevates a group of trade creditors, who previously held only unsecured claims, to the same level of priority as estate professionals.

Secured lenders generally prefer section 363 sales over a reorganization because such sales provide a relatively quick and inexpensive mechanism for their collateral to be sold and their claims paid. In furtherance of this goal, sophisticated lenders (sometimes referred to as "creditors-in-possession") have increased their control over the debtor prior to, and after, the petition date. Post-petition, because one or more secured lenders are undersecured (or, to the extent there is an equity cushion, such cushion is rapidly deteriorating), the secured lenders have leverage to insist on strict budgets and default provisions as well as expedited timeframes in cash collateral and post-petition financing orders. As such, most chapter 11 debtors and their professionals have only a short runway to attempt to reorganize. When that runway ends, a section 363 sale process is more often than not the only remaining option for maximizing value and preserving jobs.[7]

But section 363 is just one of many sections of the Bankruptcy Code. It does not contain language similar to section 1129(a)(9)(A) requiring that all administrative expenses of the estate be paid in full. That being the case, when a debtor proposes to sell substantially all of its assets in

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claim of a kind specified in section 507(a)(2) … on the effective date of the plan, the holder of such claim will receive on account of such claim cash equal to the allowed amount of such claim."

[6] 11 U.S.C. § 503(b)(9).

[7] In retail cases, section 363 sales have increasingly turned into sales to liquidators pursuant to so-called agency agreements whereby the liquidators simply conduct going out of business sales at each of the debtors' stores. This is because, in such cases, the liquidation value of the inventory is greater than the going concern value of the debtors.

a section 363 sale, the question of whether such a sale should be approved when all that remains post-closing is an administratively insolvent estate is a difficult one.

A new term of art has arisen in chapter 11 practice: the fulcrum creditor. The fulcrum creditor is the creditor who resides in the debtor's capital structure at the priority level where the firm's enterprise value is exhausted. For the reasons discussed above, fulcrum creditors have, in recent years, moved from being unsecured creditors to junior or mezzanine lenders or the holders of administrative expenses. The fulcrum creditor is the party that stands to benefit the most from the potential upside that a section 363 sale can bring to the table. Secured creditors above the fulcrum creditor in the priority ladder are generally comfortable that they will be paid in full through a liquidation of their collateral. Unsecured creditors below the fulcrum creditor in the priority ladder are often out of the money. Since the fulcrum creditor is the party that benefits the most from the potential upside of a section 363 sale, a compelling argument can be made that it is the party that should be responsible for paying the costs associated with a proposed 363 sale.

Money (That's What I Want)

Faced with limited prospects for a meaningful distribution in most recent cases, creditors' committees and holders of administrative expenses have raised a number of arguments for why a secured creditor (who may or may not be the fulcrum creditor) should be required to pay all or a portion of the administrative expenses including, but not limited to, professional fees for committee counsel and section 503(b)(9) administrative expenses. A few of these arguments are discussed below.

a. Surcharge

"The general bankruptcy rule is that, absent an express agreement to the contrary, the expenses associated with administering a bankruptcy estate are not chargeable to a secured

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creditor's collateral or claim, but must be borne out of the unencumbered assets of the estate."[8] It has been said that this rule is important because it preserves a secured creditor's collateral value, and thus ensures that secured creditors will receive the benefit of their pre-bankruptcy bargain.[9]

A limited exception to this rule is contained in section 506(c) of the Bankruptcy Code which provides that, "The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim…."[10] Additionally, expenses may be recoverable where the secured creditor expressly or impliedly consents to the incurrence of the expense.[11]

Section 506(c) was enacted as part of the Bankruptcy Reform Act of 1978. The section was a codification of an equitable doctrine in pre-code case law holding that, in limited circumstances, a lienholder could be compelled to contribute to the reasonable and necessary costs of selling the encumbered property.[12] The underlying rationale for the provision, which in essence

[8] 4 COLLIER ON BANKRUPTCY (16th Ed. Rev.), ¶ 506.05, at p. 506-116 (2017); *see also In re Visual Indus., Inc.*, 57 F.3d 321, 324 (3d Cir. 1995) ("post-petition administrative expenses and the general costs of reorganization ordinarily may not be charged to or against secured collateral."); *In re Molycorp, Inc.*, 562 B.R. 67, 75 (Bankr. D. Del. 2017) ("As a general rule, administrative expenses must be satisfied from assets of the estate not subject to liens."); *In re Lunan Family Rests. Ltd. P'ship*, 192 B.R. 173, 178 (Bankr. N.D. Ill. 1996) ("Costs of administering a bankruptcy estate must generally be borne by the estate and its general creditors, and such expenses will not ordinarily be charged against collateral of secured creditors.").

[9] *See e.g., In re Molycorp*, 562 B.R. at 75 ("A secured creditor's interest in its collateral is a substantive property right created by non-bankruptcy law, which may not be substantially impaired when bankruptcy intervenes. A secured creditor should not be deprived of the benefit of its bargain and will be protected in bankruptcy to the extent of the value of its collateral….")

[10] 11 U.S.C. § 506(c).

[11] The most common form of secured creditor consent is a "carve-out", a topic that is separately being addressed by this panel.

[12] *In re Codesco Inc.*, 18 B.R. 225, 230 (Bankr. S.D.N.Y. 1982) (citing *Maxcy v. Walker*, 119 F.2d 535, 536 (5th Cir. 1941) (noting that these costs were "usually to be measured by the actual cost in a state court of foreclosing the lien."")).

circumvents the bankruptcy priority scheme, is that "the general estate and unsecured creditors should not be required to bear the cost of protecting what is not theirs."[13]

Courts generally agree that recovery under section 506(c) is limited to the extent the fees and expenses surcharged: (i) are necessary, (ii) are reasonable, and (iii) confer a direct benefit on the secured creditor rather than the estate, the debtor, or a third party.[14] The benefit requirement is the most important and difficult to prove of the three aforementioned requirements.[15] A secured creditor receives a "benefit" within the meaning of section 506(c) if the relevant expense preserved or increased the value of its collateral. The benefit shown by the moving party cannot be nebulous or even an indirect one but must be a "concrete" and "quantifiable" benefit.[16] Because section 506(c) is an exception to the general rules of distribution in bankruptcy, courts have held that the provision must be strictly construed and given a limited application.[17]

Prior to the United States Supreme Court's decision in *In re Hen House Interstate, Inc.*,[18] there was conflicting authority concerning whether only a bankruptcy trustee could invoke section 506(c) or, alternatively, whether any holder of an administrative expense could do so. In *Hen*

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[13] *Id.*

[14] *See e.g., In re Delta Towers,* 924 F.2d 74, 76 (5th Cir. 1991) (citing *In re Trim-X, Inc.*, 695 F.2d 296, 299 (7th Cir. 1982)); *In re Chicago Lutheran Hosp. Ass'n,* 89 B.R. 719, 727 (Bankr. N.D. Ill. 1988).

[15] *See e.g., In re Daily Medical Equip., Inc.*, 150 B.R. 205, 208 (Bankr. N.D. Ohio 1992).

[16] *See e.g., In re Debbie Reynolds Hotel & Casino, Inc.*, 255 F.3d 1061, 1068 (9th Cir. 2001); *In re Grimland,* 243 F.3d 228, 232 (5th Cir. 2001).

[17] *See e.g., In re D&M Land Co., LLC,* 2010 WL 358525 at *7 (Bankr. E.D.N.C. Jan. 15, 2010) ("The Fourth Circuit has construed § 506(c) narrowly.") (citing *In re K&L Lakeland, Inc.*, 128 F.3d 203, 207 (4th Cir. 1997)); *In re Felt Mfg. Co., Inc.*, 402 B.R. 502, 528 (Bankr. D.N.H. 2009) ("[C]ourts have narrowly construed section 506(c)[.]") (quoting *United Jersey Bank v. Miller (In re C.S. Assoc.),* 29 F.3d 903, 907 (3d Cir. 1994); *In re Parr Meadows Racing Ass'n., Inc.*, 92 B.R. 30, 36 (E.D.N.Y. 1988) ("Courts have narrowly construed § 506(c) to encompass only those expenses specifically incurred for the express purpose of ensuring that the property is preserved and disposed of in a manner that provides the secured creditor with maximum value and apportions those costs to the creditor who will be assuming the asset").

[18] *Hartford Underwriters Ins. Co. v. Union Planters Bank NA (In re Hen House Interstate, Inc.),* 530 U.S. 1 (2000).

House, Hartford Underwriters provided workers' compensation insurance to the debtor (a restaurant and service station operator) during its chapter 11 proceedings. The debtor repeatedly failed to make the monthly payments due under the insurance policy, but Hartford continued to provide the insurance. The debtor's attempt at reorganization was unsuccessful, and the bankruptcy court converted the case to case under chapter 7.

Upon conversion, the debtor owed Hartford more than $50,000 on account of the policy. The chapter 7 estate had no available funds to pay Hartford's administrative claim, so Hartford sought to recover from Union Planters Bank, the debtor's pre- and post-petition secured lender. Hartford filed a motion for allowance of an administrative expense under section 503 and to charge against the bank's collateral under section 506(c). It argued that the insurance it provided the debtor benefited the bank by allowing the debtor to continue to operate its business, and thus preserved the bank's collateral. Hartford also argued that the bank's consent to a post-petition financing order, under which the debtor was authorized to pay the insurance expenses from cash collateral, implied a direct benefit to the bank.

The bankruptcy court ruled in favor of the insurer, allowing it to surcharge the bank's collateral. The district court and the Eighth Circuit affirmed. However, the Eighth Circuit subsequently granted *en banc* review and reversed, concluding that section 506(c) could not be invoked by an administrative claimant.

Justice Scalia, writing for a unanimous Supreme Court, first noted that "administrative expenses … do not have priority over secured claims."[19] However, section 506(c) is "an important exception to the rule that secured claims are superior to administrative claims."[20] Turning to the

[19] *Id.* at 5.

[20] *Id.*

language of section 506(c), the Court decided that the text of the statute was clear: "[T]he trustee is the only party empowered to invoke the provision."[21] "[H]ad Congress intended the provision to be broadly available, it could simply have said so, as it did in describing the parties who could act under other sections of the Code."[22] Notwithstanding various policy concerns raised by Hartford, the court found that the holder of an administrative expense has no right to pursue its administrative expense against the secured lender.[23]

The clear takeaway from the Supreme Court's ruling is that section 506(c) does not provide a remedy for non-trustee/debtor[24] holders of administrative expenses who are seeking to charge a secured lender for the costs associated with a section 363 sale of its collateral. In the absence of a statutory remedy, what arguments can holders of administrative expenses make?

Ensuring Administrative Insolvency is an Implied Requirement of a 363 Sale

Perhaps the best argument for holders of administrative expenses is that a bankruptcy court should not approve a sale process it if will only benefit the secured creditor.[25] This is particularly true where the case is, or will be, administratively insolvent. As noted, all administrative expenses must generally be paid in full in order to confirm a plan under section 1129 of the Bankruptcy Code. If the case is filed to orchestrate a pre-plan section 363 sale, then there must be sufficient

[21] *Id.* at 6.

[22] *Id.* at 7 (citing 11 U.S.C. 502(a) and 503(b)(4)).

[23] *Id.*

[24] Importantly, the Court stated in a footnote that a debtor in possession, given trustee powers by section 1107, may also bring section 506(c) actions. *Id.* at n. 3.

[25] *But see In re GPA Technical Consultants, Inc.*, 106 B.R. 139, 142 (Bankr. S.D. Ohio 1989), wherein the court determined that it is not *per se* inappropriate for a bankruptcy liquidation to proceed where it will only benefit the secured creditor, stating: "Even if the only reason for the Chapter 11 in the instant case is to maximize the return to the secured creditor … the interests of the secured creditor are legitimate interests to be taken into account…. Pursuant to [the Bankruptcy Code], entities holding secured claims are 'creditors.'"

assets carved out from the sale to pay all costs of administration. If the secured creditors are unwilling to pay the costs associated with the sale, the argument goes, then they should be required to liquidate their collateral in state court (through an article 9 foreclosure and sale) without the benefits of having the process conducted in chapter 11. In other words, if a secured creditor desires to liquidate its collateral through a section 363 sale, paying the freight is the price of admission. A few courts have addressed this argument.

a. *In re Gulf Coast Oil Corp.*

In *In re Gulf Coast Oil Corp.*,[26] an oil and gas exploration company filed a bankruptcy case in the United States Bankruptcy Court for the Southern District of Texas. After six relatively contentious months as a debtor in possession, when it became clear that a reorganization was not possible, the debtors filed a motion to sell substantially all of their assets to the sole secured lender, who held a lien on all assets, through a credit bid. The debtors' financial advisor, who held an administrative expense that would not be paid in full, objected to the sale. The court denied the sale motion, concluding that the debtors had not demonstrated a substantial business reason for conducting a section 363 sale in lieu of a sale pursuant to, and in accordance with the requirements of, a liquidating chapter 11 plan.

The court first noted that sales in bankruptcy can be accomplished under section 363(b) (when a substantial business justification for approving the sale is established) or under section 1123 of the Bankruptcy Code, which provides that a chapter 11 plan may including provisions providing for the sale of estate property. The court noted that "The Bankruptcy Code does not

[26] *In re Gulf Coast Oil Corp.*, 404 B.R. 407 (Bankr. S.D. Tex. 2009).

provide any explicit guidance to determine when § 363(b) is the appropriate procedure and when § 1123 is the appropriate procedure."[27]

The court then engaged in an analysis of the jurisprudence in the Fifth Circuit regarding the approval of section 363 sales.[28] The court also reviewed the analysis set forth in the two primary bankruptcy treatises, COLLIER ON BANKRUPTCY and NORTON BANKRUPTCY LAW & PRACTICE, and in several scholarly articles.[29] After discussing the recent changes in chapter 11 bankruptcy practice, the court acknowledged that there has been "a huge increase in motions to sell substantial parts (or all) of the estate under § 363(b) prior to plan confirmation."[30] The court ultimately concluded, "the bankruptcy court must not authorize a § 363(b) transaction if the transaction would effectively evade the 'carefully crafted scheme' of the chapter 11 plan confirmation process."[31]

Next, the court identified no fewer than 13 factors that a bankruptcy judge must consider in deciding a pre-plan motion to sell substantial assets under section 363(b).[32] Although it applied

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[27] *Id.* at 415.

[28] *Id.* at 415-417 (discussing *In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983) (holding that an asset sale which provides for more than a transfer of assets for value effectively "short circuits the requirements of Chapter 11 … by establishing the terms of the plan *sub rosa* ... [and] cannot be authorized under § 363(b)); *Richmond Leasing Co. v. Capital Bank N.A.*, 762 F.2d 1303 (5th Cir. 1985) (stating, in dicta, that "the disposition of a 'crown jewel' asset might, in combination with other factors, severely restrict a future reorganization plan so as to amount to a *sub rosa* plan of reorganization…"); *In re Continental Air Lines, Inc.*, 780 F.2d 1223 (5th Cir. 1986) ("Undertaking reorganization piecemeal pursuant to § 363(b) should not deny creditors the protections they would receive if the proceeds were first raised in the reorganization plan."); *In re Babcock and Wilcox Co.*, 250 F.3d 955 (5th Cir. 2001) ("the provisions of § 363 … do not allow a debtor to gut the bankruptcy estate before reorganization or to change the fundamental nature of the estate's assets in such a way that limits a future reorganization plan.")).

[29] *Id.* at 417-419.

[30] *Id.* at 418-422.

[31] *Id.* at 422.

[32] The 13 factors identified by Judge Steen are as follows:

(i) Is there evidence of a need for speed?
(ii) What is the business justification?

each of these factors to the facts of the case, the court focused heavily on the tenth factor, to wit: Who will benefit from the sale? The court stated:

> If only one party … will benefit from the sale, the movant should be prepared to explain why the sale should take place in a bankruptcy case and why the bankruptcy court should provide the benefits for which Congress imposed substantial requirements. If the sale will not follow the "carefully crafted [Congressional] scheme" by utilizing the "balanced set of tools for both the debtor and the creditor [and] ... multiparty bargaining" then it is hard to justify entitling the few lucky parties to the extraordinary benefits that Congress provided for those who do satisfy the statutory plan confirmation requirements.
>
> [B]ankruptcy is, at its essence, a collective remedy intended to benefit all creditors, not just the secured lender. The § 363(b) movant should be prepared to prove, not just allege, why it is appropriate to provide extraordinary bankruptcy authority and remedies solely for the benefit of a party whose contract under state law does not provide those remedies and benefits. And if the proposed transaction will not even pay all of the expenses of the bankruptcy proceeding, it would be especially difficult to understand why the purchaser should get the benefit of extraordinary bankruptcy powers and remedies for which it did not pay.[33]

Ultimately, the court rejected the sale motion because the debtor had not established a sufficient business justification for approving the section 363(b) sale prior to plan confirmation. The court reasoned that it saw "no authority to provide the benefits of the Congressional scheme … without compliance with Congressional requirements."[34] Notably, the court expressed grave

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(iii) Is the case sufficiently mature to assure due process?
(iv) Is the proposed APA sufficiently straightforward to facilitate competitive bids or is the purchaser the only potential interested party?
(v) Have the assets been aggressively marketed in an active market?
(vi) Are the fiduciaries that control the debtor truly disinterested?
(vii) Does the proposed sale include all of the debtor's assets and does it include the "crown jewel"?
(viii) What extraordinary protections does the purchaser want?
(ix) How burdensome would it be to propose the sale as part of a confirmation of a chapter 11 plan?
(x) Who will benefit from the sale?
(xi) Are special adequate protection measures necessary and possible?
(xii) Is the integrity of the bankruptcy process protected?, and
(xiii) Other factors that apply to the case at hand.

[33] *Id.* at 426-27.

[34] *Id.* at 428.

concern that it could not make the finding required in the plan context by section 1129(a)(9) that all of the administrative expenses will be paid in full.

Subsequently, a handful of courts have adopted the reasoning in *In re Gulf Coast Oil Corp.* when evaluating section 363 sale motions. For example, in *In re Flour City Bagels,* the United States Bankruptcy Court for the Western District of New York relied on *Gulf Coast Oil Corp.* in denying a proposed section 363 sale because, among other reasons, the proposed bid raised "serious concerns that the sale, if approved, would result in [the debtor] being rendered administratively insolvent."[35] In *In re On-Site Sourcing, Inc.*, the United States Bankruptcy Court for the Eastern District of Virginia approved a pre-plan section 363 sale but, in doing so, excised certain sale conditions which would likely result in inadequate funds to pay all administrative expenses in full.[36]

b. *In re Encore Healthcare Associates*

In *In re Encore Healthcare Associates*[37] the debtor, a lessor of real property that housed a nursing facility, filed a bankruptcy case in the United States Bankruptcy Court for the Eastern District of Pennsylvania. The debtor's assets were valued at about $2.5 million. The assets secured a debt to the secured lender, Greenleaf, of approximately $8.4 million. The debtor sought authority to sell the assets for $2.5 million, with the sale proceeds to pay the costs of sale and then all of the remainder to be remitted to the secured creditor in partial satisfaction of its claim.

No parties objected to the proposed sale, but the bankruptcy court *sua sponte* raised its own concerns. The court began its analysis by stating that section 363 does not grant a debtor an

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[35] *In re Flour City Bagels, LLC,* 557 B.R. 53, 79-80 (Bankr. W.D.N.Y. 2016).

[36] *In re On-Site Sourcing, Inc.*, 412 B.R. 817, 827-28 (Bankr. E.D. Va. 2009).

[37] *In re Encore Healthcare Assocs.*, 312 B.R. 52 (Bankr. E.D. Pa. 2004).

absolute right to sell its assets. Instead, there must be some business justification other than appeasement of major creditors.[38] Specifically, the court stated, "The debtor applying under § 363(b) must demonstrate that a sale will aid the debtor's reorganization."[39] In the present case, the court noted, there was not going to be a reorganization as the debtor acknowledged that it planned to convert the case to chapter 7 following the sale.

Finding that the bankruptcy sale was effectively a state law foreclosure negotiated pre-petition, the court stated:

> While this Court understands [the purchaser's] interest in acquiring the assets along with a bankruptcy order insulating it from future claims and providing a federal forum to litigate any contract issues, I am hard pressed to see why the bankruptcy court should assume jurisdiction over this sale.[40]

The court also quoted a bankruptcy opinion from the United States Bankruptcy Court for the Northern District of Ohio, *In re Fremont Battery Co.,* stating:

> The proposed sale would not, as a whole benefit the Debtor or creditors. In fact, if allowed, the sale would terminate Debtor's existence. If Debtor's proposed sale were authorized, the likelihood of reorganization would dissipate as there would remain no assets from which a plan could be proposed. Additionally, the proceeds from the proposed sale would, at most, benefit one creditor only. The sale would not create proceeds that would inure to the benefit of the unsecured creditors.[41]

The court acknowledged that pre-plan sales of assets are often an important step in furtherance of a reorganization proceeding. For example, if a sale is proposed at a time when the debtor lacks funds to continue operating, the assets are declining in value and the proceeds "ensure[] the payment of administrative claims," a sale outside a plan may be proper.[42] Here,

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[38] *Id.* at 54-55 (citing and discussing *Committee of Equity Security Holders v. The Lionel Corporation (In re Lionel Corp.),* 722 F.2d 1063 (2d Cir. 1983)).

[39] *Id.* at 55.

[40] *Id.* at 55-56.

[41] *Id.* at 57 (discussing *In re Fremont Battery Co.,* 73 B.R. 277 (Bankr. N.D. Ohio 1987)).

[42] *Id.* (citing *In re Medical Software Solutions,* 386 B.R. 431 (Bankr. D. Utah 2002)) (emphasis added).

however, the sale would generate funds solely for the secured creditor, "which could realize the value of its collateral by foreclosing and selling the assets itself."[43] The proposed sale, the court found: "advances no purpose of a Chapter 11 proceeding," as it would preserve no operating business with continued employment for workers, and the debtor intended to convert the case to chapter 7 shortly after consummation of the sale.[44] Accordingly, the court denied the proposed sale motion.

c. ***In re Family Christian, LLC***

Recently, an opinion from the United States Bankruptcy Court for the Western District of Michigan in *In re Family Christian, LLC*[45] has been cited for the proposition that a lender, who stands largely to benefit from a sale of its collateral under section 363, must ensure payment of all administrative expenses. Whether that was in fact the holding of the court (the case had some unique facts, involving a proposed sale to an insider) or, alternatively, just part of the court's rationale is debatable, but it does appear that the specter of administrative insolvency was a concern that weighed heavily on the court when it determined that it could not approve a pre-plan section 363 sale to any of three different potential buyers.

In *Family Christian,* the debtors operated as not-for-profit organizations, selling religious merchandise in more than 250 brick and mortar stores. On the petition date, the debtors' assets were valued at approximately $28 million against secured debt (a portion of which was held by an insider) totaling about $58 million. Administrative expenses totaled approximately $14 million, $5.6 million of which were section 503(b)(9) administrative expenses.

[43] *Id.*

[44] *Id.* at 57-58.

[45] *In re Family Christian, LLC,* 533 B.R. 600 (Bankr. W.D. Mich. 2015).

Immediately after commencing its chapter 11 case in February 2015, the debtors moved to sell substantially all of their assets to FCS Acquisition, an entity controlled by an insider. After opposition from numerous creditors and other parties in interest, however, the debtors withdrew their initial sale motion. Thereafter, the debtors returned to court with a revised sale process and obtained approval of consensual bidding procedures with no stalking horse bidder.

After an auction that was "nothing short of chaotic,"[46] two status conferences, a request from certain non-insider bidders that the court supervise the auction process, and a second day of bidding, the bidders left standing were: (i) FCS Acquisition, which proposed to buy the debtors' assets for a bid valued at $46.8 million, and (ii) two separate bids from liquidators who proposed to liquidate the debtors' inventory through going out of business sales under so-called "agency agreements." Even though the liquidators' bids were valued at approximately $3 million more than the insider bid, FCS Acquisition was declared the winner by the debtors, purportedly because the liquidators' bids contained various contingencies and did not guarantee a minimum purchase price. Unlike the liquidators' bids, the insider's bid guaranteed that administrative expenses, including professional fees subject to certain caps, would receive payment in full.

After a lengthy contested sale hearing, the bankruptcy court denied the proposed sale to the insider because the debtors had failed to articulate a sound business justification for the sale. The court found that no party in interest had shown any relationship between the proposed sale price and the value of the assets being sold (which, importantly, included insider releases and a waiver of all avoidance actions, which had not been valued). Moreover, the court expressed concerns about the good faith of the insider entity. Finally, although the court did not cite *In re Gulf Coast Oil Corp.*, it stated that it was also concerned that the proposed sale would essentially circumvent

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[46] *Id.* at 610.

the requirements inherent in confirming a chapter 11 plan. The court stated, "In these cases, the Acquisition APA contains provisions which are more appropriately included within the plan of liquidation that the Debtors intend to file, especially in light of the insider relationship between the Debtors and Acquisition."[47]

Relevant to the topic of this paper, the court determined that it also could not approve the sale to the liquidators who had been designated as the back-up bidders at the auction. Part of its rationale for rejecting the liquidators' bids was that the liquidators had "failed to provide any firm commitment to this court regarding the payment in full of administrative expenses. The court therefore cannot conclude that the [liquidators' bids were] the highest and best bid."[48]

The court entered an order specifying that if the auction were reopened, any qualifying bid must, among several other requirements, provide for payment of administrative expenses. Alternatively, the court suggested in its opinion that the debtors may consider selling their assets though a plan, which would avoid its concerns that certain elements of their proposed sale were inconsistent with the Bankruptcy Code and improper in the context of a pre-plan section 363 sale. That is exactly what the debtors ended up doing, and the assets were eventually sold as part of a liquidating plan.

Are All Administrative Expenses Created Equal?

The Bankruptcy Code makes no distinction between administrative expenses for post-petition professional fees or operating expenses and pre-petition administrative expenses under section 503(b)(9). None of the opinions discussed above made such a distinction either. Nevertheless, in the context of deciding whether a proposed sale that leaves behind an

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[47] *Id.* at 629.

[48] *Id.* at 630-31.

administratively insolvent estate can be approved, there appears to be a split in the case law in Delaware regarding whether administrative expenses under section 503(b)(9) are truly equal to administrative expenses incurred post-petition.

For example, in *In re Townsends, Inc.*,[49] Judge Sontchi initially refused to approve proposed DIP financing and a sale process because the debtors and the secured lender had failed to provide reasonable certainty that administrative expenses would be paid in full through the sales process. The court prohibited the lenders from treating section 503(b)(9) administrative expenses differently from other administrative expenses. Additionally, in *In re NEC Holdings Corp.*,[50] objections to DIP financing and a proposed sale were asserted because no guarantee was provided that section 503(b)(9) administrative expenses would be paid in full. Judge Walsh held that where the secured lender is the primary beneficiary of a sale, it has "to pay the freight, and the freight is not necessarily a tip to the unsecured, but the freight is certainly an administratively solvent estate." After the lender and the creditors' committee subsequently reached an agreement to pay section 503(b)(9) administrative expenses from the sale proceeds, the proposed DIP financing and sale process were approved.

Conversely, in *In re Allen Family Foods, Inc.*,[51] Judge Carey approved a section 363 sale notwithstanding the fact that the pre-petition secured lenders did not assure full payment of section 503(b)(9) administrative expenses. The court distinguished administrative expenses arising under section 503(b)(9) from other administrative expenses because the holders of such claims made no "ongoing contribution to the chapter 11 case." The same conclusion was reached by Judge

[49] *In re Townsends, Inc.*, Case No. 10-14092 (CSS) (Bankr. D. Del. 2010).

[50] *In re NEC Holdings Corp.*, Case No. 10-11890 (PJW) (Bankr. D. Del. 2011).

[51] *In re Allen Family Foods, Inc.*, Case No. 11-11764 (KJC) (Bankr. D. Del. 2011).

Shannon in *In re Real Mex Restaurants Inc.*,[52] who approved a section 363 sale despite the fact that section 503(b)(9) administrative expenses would not be paid in full, noting that "the circumstances for all creditors would be much worse without this sale."

Despite the fact that the Bankruptcy Code makes no distinction between pre-petition and post-petition administrative expenses, the tension reflected in the intra-district split discussed above highlights how difficult this issue is. Understandably, it is hard for bankruptcy courts to reject a sale, on the basis that it does not pay all administrative expenses in full or discriminates amongst different types of administrative expenses, when such a sale may be the best of several less than appealing options.

Conclusion

There is certainly additional precedent in the case law for the concept that secured creditors must fund certain administrative expenses in a case, particularly the fees owed to estate professionals, in order to ensure that the adversarial process contemplated in chapter 11 exists.[53] Nevertheless, despite the frequency with which these issues arise in modern chapter 11 practice, there is surprisingly little case law discussing whether a secured creditor should be required to "pay the freight" when its assets are to be sold in a section 363 sale. This may be because debtors, secured creditors, creditors' committees and other parties holding administrative expenses

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[52] *In re Real Mex Restaurants Inc.*, Case No. 11-13122 (BLS) (Bankr. D. Del. 2011).

[53] For example, in *In re Ames Dept. Stores, Inc.*, the United States Bankruptcy Court for the Southern District of New York famously stated as follows in analyzing proposed DIP financing:

> No court of which we are aware has approved financing arrangements with such features. Indeed, it has been the uniform practice in this Court … to insist on a carve out from a super-priority status and post-petition lien in a reasonable amount designed to provide for payment of the fees of debtor's and the committees' counsel and possible trustee's counsel in order to preserve the adversary system. Absent such protection, the collective rights and expectations of all parties-in-interest are sorely prejudiced.

In re Ames Department Stores, 115 B.R. 34 (Bankr. S.D.N.Y. 1990).

generally negotiate a resolution of this issue, given the high stakes that often surround a sale of substantially all of a debtor's assets.

A bankruptcy court cannot force a secured creditor to pay all administrative expenses in full. But it can conclude, as some have, that it should not approve a proposed sale process where a sale will leave behind an administratively insolvent estate. Although section 363 sales may have supplanted confirmation of a plan as the preferred exit strategy for business debtors, it is fair in administratively insolvent cases to expect that the parties benefitting the most from such process ensure that the related, reasonable, costs are paid in full. That is the price of admission for obtaining the benefits that chapter 11 can provide, and is arguably what was contemplated by the drafters of the Bankruptcy Code who could not have anticipated the extent to which section 363 is used today.

At the end of the day, the analysis should focus on who is the fulcrum creditor. That party may or may not be the senior secured creditor. However, it is the fulcrum creditor who needs to decide whether they want the benefits and potential upside that accompanies a section 363 sale process, or not. If the decision is made to proceed under section 363, the burden of "paying the freight" should fall squarely on their shoulders.