Representing the Corporate Client in Bankruptcy

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36TH ANNUAL MIDWESTERN BANKRUPTCY INSTITUTE

REPRESENTING THE CORPORATE CLIENT IN BANKRUPTCY

SELECT RULES AND CASE EXAMPLES

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A. APPLICABLE RULES OF PROFESSIONAL CONDUCT[2]

1. ABA Model Rule 1.7. Conflict Of Interest: Current Clients

(a) Except as provided in paragraph (b), 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.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

2. ABA Model Rule 1.8. Conflict Of Interest: Current Clients: Specific Rules

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;

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[2] The ABA Model Rules of Professional Conduct and Comments referenced herein are quoted in their entirety and can be found at http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/model_rules_of_professional_conduct_table_of_contents.html. ©2016 by the American Bar Association.

(2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and

(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

(b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent, except as permitted or required by these Rules.

(c) A lawyer shall not solicit any substantial gift from a client, including a testamentary gift, or prepare on behalf of a client an instrument giving the lawyer or a person related to the lawyer any substantial gift unless the lawyer or other recipient of the gift is related to the client. For purposes of this paragraph, related persons include a spouse, child, grandchild, parent, grandparent or other relative or individual with whom the lawyer or the client maintains a close, familial relationship.

(d) Prior to the conclusion of representation of a client, a lawyer shall not make or negotiate an agreement giving the lawyer literary or media rights to a portrayal or account based in substantial part on information relating to the representation.

(e) A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:

(1) a lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter; and

(2) a lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client.

(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:

(1) the client gives informed consent;

(2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and

(3) information relating to representation of a client is protected as required by Rule 1.6.

(g) A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, or in a criminal case an aggregated agreement as to guilty or nolo contendere pleas, unless each client gives informed consent, in a writing signed by the client. The lawyer's disclosure shall include the existence and nature of all the claims or pleas involved and of the participation of each person in the settlement.

(h) A lawyer shall not:

(1) make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement; or

(2) settle a claim or potential claim for such liability with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith.

(i) A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:

(1) acquire a lien authorized by law to secure the lawyer's fee or expenses; and

(2) contract with a client for a reasonable contingent fee in a civil case.

(j) A lawyer shall not have sexual relations with a client unless a consensual sexual relationship existed between them when the client-lawyer relationship commenced.

(k) While lawyers are associated in a firm, a prohibition in the foregoing paragraphs (a) through (i) that applies to any one of them shall apply to all of them.

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3. ABA Model Rule 1.9 Duties To Former Clients

(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, confirmed in writing.

(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, confirmed in writing.

(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.

4. ABA Model Rule 1.10. Imputation of Conflicts Of Interest: General Rule

(a) While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by Rules 1.7 or 1.9, unless

(1) the prohibition is based on a personal interest of the disqualified lawyer and does not present a significant risk of materially limiting the representation of the client by the remaining lawyers in the firm; or

(2) the prohibition is based upon Rule 1.9(a) or (b) and arises out of the disqualified lawyer's association with a prior firm, and

(i) the disqualified lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom;

(ii) written notice is promptly given to any affected former client to enable the former client to ascertain compliance with the provisions of this Rule, which shall include a description of the screening procedures employed; a statement of the firm's and of the screened lawyer's compliance with these Rules; a statement that review may be available before a tribunal; and an agreement by the firm to respond promptly to any written inquiries or objections by the former client about the screening procedures; and

(iii) certifications of compliance with these Rules and with the screening procedures are provided to the former client by the screened lawyer and by a partner of the firm, at reasonable intervals upon the former client's written request and upon termination of the screening procedures.

(b) When a lawyer has terminated an association with a firm, the firm is not prohibited from thereafter representing a person with interests materially adverse to those of a client represented by the formerly associated lawyer and not currently represented by the firm, unless:

(1) the matter is the same or substantially related to that in which the formerly associated lawyer represented the client; and

(2) any lawyer remaining in the firm has information protected by Rules 1.6 and 1.9(c) that is material to the matter.

(c) A disqualification prescribed by this rule may be waived by the affected client under the conditions stated in Rule 1.7.

(d) The disqualification of lawyers associated in a firm with former or current government lawyers is governed by Rule 1.11.

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B. APPLICABLE BANKRUPTCY CODE SECTIONS AND RULES

1. 11 U.S.C. § 327. Employment of Professional Persons

(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.

(b) If the trustee is authorized to operate the business of the debtor under section 721, 1202, or 1108 of this title, and if the debtor has regularly employed attorneys, accountants, or other professional persons on salary, the trustee may retain or replace such professional persons if necessary in the operation of such business.

(c) In a case under chapter 7, 12, or 11 of this title, 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.

(d) The court may authorize the trustee to act as attorney or accountant for the estate if such authorization is in the best interest of the estate.

(e) The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.

(f) The trustee may not employ a person that has served as an examiner in the case.

11 U.S.C. § 327.

2. 11 U.S.C § 328(c). Limitation on Compensation of Professional Persons

(c) Except as provided in section 327(c), 327(e), or 1107(b) of this title, the court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under section 327 or 1103 of this title if, at any time during such professional person's employment under section 327 or 1103 of this title, such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed.

11 U.S.C. § 328(c).

3. Bankruptcy Rule 2014. Employment of Professional Persons

(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 [11 USCS § 327, 1103, or 1114] 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.

(b) *Services rendered by member or associate of firm of attorneys or accountants.* If, under the Code and this rule, a law partnership or corporation is employed as an attorney, or an accounting partnership or corporation is employed as an accountant, or if a named attorney or accountant is employed, any partner, member, or regular associate of the partnership, corporation or individual may act as attorney or accountant so employed, without further order of the court.

Fed. R. Bankr. P. 2014.

C. CASE EXAMPLES

1. *In re Interwest Business Equipment Inc.*, 23 F.3d 311 (10th Cir. 1994).

Interwest Business Equipment Inc., Green Street, Retail Systems Inc., and the individual who controlled each of the corporations filed Chapter 11 bankruptcy petitions. One law firm applied to represent all three of the corporate debtors. An investigation revealed three substantial intercompany debts, but there was no indication of whether there were possibilities of avoiding transfers between the three debtors. There was also a management contract between Green Street and Retail that the two debtors intended to maintain. The bankruptcy court denied the application for one law firm to represent all three debtors because it found conflicts of interest.

One conflict existed because there was a debtor–creditor relationship between the companies, meaning that the firm would be representing an adverse interest to the estate and would not be disinterested. The bankruptcy court also found a conflict in representing associated estates. "These interlocking interests can only be served by utilizing separate counsel who can fairly and fully advise each debtor as to its rights and responsibilities." *Id*. at 314 (quoting *In re Green Street*, 132 B.R. 460, 462 (Bankr. D. Utah 1991). The district court and Court of Appeals agreed. The court of appeals noted that § 327(c) did not preclude finding a conflict because the dual representation of a creditor was not the sole reason for the bankruptcy's denial of representation. The bankruptcy court was also concerned with the representation of related debtors. Without separate counsel, the attorneys may not be willing to scrutinize the payments made prior to filing, the payments to insiders, the benefit of executory contracts, or the claims of the creditors that were related to the other entities.

2. *In re Big Mac Marine, Inc.,* 326 B.R. 150 (B.A.P. 8th Cir. 2005).

This case involved an attorney who wanted to represent debtors in two different Chapter 11 cases. The debtor in one Chapter 11 case was a family business involved in selling boats. The parents originally owned the business and had personally guaranteed the business's loans. The parents then sold the business to their son. The parents filed a Chapter 11 bankruptcy. In the parents' Chapter 11 case, they challenged the bank's security interest. Nine months after the parents filed bankruptcy, the family business filed a Chapter 11 petition. The parents were the largest creditor and claimed have a secured interest in the business's inventory, despite the lack of documentation to support their secured claim. The same attorney who represented the parents filed an application to represent the family business in its Chapter 11 case. The bankruptcy court denied the application because the attorney was not disinterested and represented adverse interests. The parents later withdrew their claim against the family business, but they remained the sole shareholders and still challenged the bank's security interest. The bankruptcy court denied the attorney's second attempt to become the attorney for the family business. The B.A.P. affirmed, finding that there was an actual conflict of interest in wanting to represent the largest creditor and sole shareholders in the family business's bankruptcy case.

3. *In re M & M Marketing, L.L.C.,* 426 B.R. 796 (B.A.P. 8th Cir. 2010).

An attorney represented a group of petitioning creditors who were related to the debtor's principal. The trustee filed an application to have the attorney represent the trustee for the purpose of pursuing avoidable or fraudulent transfers. At the hearing, the trustee stated that the attorney's role would be limited to one particular creditor, not the creditors that the attorney represented. The bankruptcy court approved of the application because the attorney had only a limited role. The B.A.P. reversed. The court found that the petitioning creditors had an adverse interest to the estate, which was imputed to the attorney. The petitioning creditors were adverse because they received transfers from the debtor that could be avoidable. Even if it were possible to limit the attorney's role to one particular creditor, the court found that this should be in writing, and not merely mentioned at the hearing. Finally, the court noted that there is a potential for litigation between the petitioning creditors and the other creditor, which would lead to divided loyalties for the attorney. Therefore, the court held that the attorney had a conflict and could not represent the estate.

4. *In re Premier Farms, L.C.*, 305 B.R. 717 (Bankr. N.D. Iowa 2003).

Debtor-in-possession filed an application to have a law firm represent it in a Chapter 11 case. The law firm represented the debtor's largest creditor on unrelated matters, and another creditor objected to the application. The bankruptcy court denied the application for the law firm to represent the debtor. The court found that the law firm "has an adverse interest and is therefore not disinterested, because it has a predisposition to bias in favor of [creditor]. [Creditor] is a client. It has been one for at least nearly two years." *Id*. at 720. The court also stated that the law firm "might be affected in its handling of the case by a desire not to make a regular client angry." *Id*. at 721. Therefore, the law firm could not represent the debtor.

II. FEES

A. APPLICABLE RULES OF PROFESSIONAL CONDUCT

1. ABA Model Rule 1.5. Fees

(a) A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses. 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; and

(8) whether the fee is fixed or contingent.

(b) The scope of the representation and the basis or rate of the fee and expenses for which the client will be responsible shall be communicated to the client, preferably in writing, before or within a reasonable time after commencing the representation, except when the lawyer will charge a regularly represented client on the same basis or rate. Any changes in the basis or rate of the fee or expenses shall also be communicated to the client.

(c) A fee may be contingent on the outcome of the matter for which the service is rendered, except in a matter in which a contingent fee is prohibited by paragraph (d) or other law. A contingent fee agreement shall be in a writing signed by the client and shall state the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer in the event of settlement, trial or appeal; litigation and other expenses to be deducted from the recovery; and whether such expenses are to be deducted before or after the contingent fee is calculated. The agreement must clearly notify the client of any expenses for which the client will be liable whether or not the client is the prevailing party. Upon conclusion of a contingent fee matter, the lawyer shall provide the client with a written statement stating the outcome of the matter and, if there is a recovery, showing the remittance to the client and the method of its determination.

(d) A lawyer shall not enter into an arrangement for, charge, or collect:

(1) any fee in a domestic relations matter, the payment or amount of which is contingent upon the securing of a divorce or upon the amount of alimony or support, or property settlement in lieu thereof; or

(2) a contingent fee for representing a defendant in a criminal case.

(e) A division of a fee between lawyers who are not in the same firm may be made only if:

(1) the division is in proportion to the services performed by each lawyer or each lawyer assumes joint responsibility for the representation;

(2) the client agrees to the arrangement, including the share each lawyer will receive, and the agreement is confirmed in writing; and

(3) the total fee is reasonable.

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B. APPLICABLE BANKRUPTCY CODE SECTIONS AND RULES

1. 11 U.S.C. § 329. Debtor's transactions with Attorneys

(a) Any attorney representing a debtor in a case under this title, or in connection with such a case, whether or not such attorney applies for compensation under this title, shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation.

(b) If such compensation exceeds the reasonable value of any such services, the court may cancel any such agreement, or order the return of any such payment, to the extent excessive, to--

(1) the estate, if the property transferred--

(A) would have been property of the estate; or

(B) was to be paid by or on behalf of the debtor under a plan under chapter 11, 12, or 13 of this title; or

(2) the entity that made such payment.

11 U.S.C. § 329.

2. 11 U.S.C. § 330. Compensation of Officers

(a) (1) After notice to the parties in interest and the United States Trustee and a hearing, and subject to sections 326, 328, and 329 [11 USCS §§ 326, 328, and 329], the court may award to a trustee, a consumer privacy ombudsman appointed under section 332 [11 USCS § 332], an examiner, an ombudsman appointed under section 333 [11 USCS § 333], or a professional person employed under section 327 or 1103 [11 USCS § 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.

(2) The court may, on its own motion or on the motion of the United States Trustee, the United States Trustee for the District or Region, the trustee for the estate, or any other party in interest, award compensation that is less than the amount of compensation that is requested.

(3) In determining the amount of reasonable compensation to be awarded to an examiner, trustee under chapter 11 [11 USCS §§ 1101 et seq.], or professional person, the court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including--

(A) the time spent on such services;

(B) the rates charged for such services;

(C) whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title;

(D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed;

(E) with respect to a professional person, whether the person is board certified or otherwise has demonstrated skill and experience in the bankruptcy field; and

(F) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.

(4) (A) Except as provided in subparagraph (B), the court shall not allow compensation for—

(i) unnecessary duplication of services; or

(ii) services that were not—

(I) reasonably likely to benefit the debtor's estate; or

(II) necessary to the administration of the case.

(B) In a chapter 12 or chapter 13 case in which the debtor is an individual, the court may allow reasonable compensation to the debtor's attorney for representing the interests of the debtor in connection with the bankruptcy case based on a consideration of the benefit and necessity of such services to the debtor and the other factors set forth in this section.

(5) The court shall reduce the amount of compensation awarded under this section by the amount of any interim compensation awarded under section 331, and, if the amount of such interim compensation exceeds the amount of compensation awarded under this section, may order the return of the excess to the estate.

(6) Any compensation awarded for the preparation of a fee application shall be based on the level and skill reasonably required to prepare the application.

(7) In determining the amount of reasonable compensation to be awarded to a trustee, the court shall treat such compensation as a commission, based on section 326.

(b) (1) There shall be paid from the filing fee in a case under chapter 7 of this title $ 45 to the trustee serving in such case, after such trustee's services are rendered.

(2) The Judicial Conference of the United States—

(A) shall prescribe additional fees of the same kind as prescribed under section 1914(b) of title 28; and

(B) may prescribe notice of appearance fees and fees charged against distributions in cases under this title; to pay $ 15 to trustees serving in cases after such trustees' services are rendered. Beginning 1 year after the date of the enactment of the Bankruptcy Reform Act of 1994, such $ 15 shall be paid in addition to the amount paid under paragraph (1).

(c) Unless the court orders otherwise, in a case under chapter 12 or 13 of this title, the compensation paid to the trustee serving in the case shall not be less than $ 5 per month from any distribution under the plan during the administration of the plan.

(d) In a case in which the United States trustee serves as trustee, the compensation of the trustee under this section shall be paid to the clerk of the bankruptcy court and deposited by the clerk into the United States Trustee System Fund established by section 589a of title 28.

3. Rule 2016. Compensation for Services Rendered and Reimbursement of Expenses

(a) *Application for compensation or reimbursement.* An entity seeking interim or final compensation for services, or reimbursement of necessary expenses, from the estate shall file an application setting forth a detailed statement of (1) the services rendered, time expended and expenses incurred, and (2) the amounts requested. An application for compensation shall include a statement as to what payments have theretofore been made or promised to the applicant for services rendered or to be rendered in any capacity whatsoever in connection with the case, the source of the compensation so paid or promised, whether any compensation previously received has been shared and whether an agreement or understanding exists between the applicant and any other entity for the sharing of compensation received or to be received for services rendered in or in connection with the case, and the particulars of any sharing of compensation or agreement or understanding therefor, except that details of any agreement by the applicant for the sharing of compensation as a member or regular associate of a firm of lawyers or accountants shall not be required. The requirements of this subdivision shall apply to an application for compensation for services rendered by an attorney or accountant even though the application is filed by a creditor or other entity. Unless the case is a chapter 9 municipality case, the applicant shall transmit to the United States trustee a copy of the application.

(b) *Disclosure of compensation paid or promised to attorney for debtor.* Every attorney for a debtor, whether or not the attorney applies for compensation, shall file and transmit to the United States trustee within 14 days after the order for relief, or at another time as the court may direct, the statement required by § 329 of the Code including whether the attorney has shared or agreed to share the compensation with any other entity. The statement shall include the particulars of any such sharing or agreement to share by the attorney, but the details of any agreement for the sharing of the compensation with a member or regular associate of the attorney's law firm shall not be required. A supplemental statement shall be filed and transmitted to the United States trustee within 14 days after any payment or agreement not previously disclosed.

(c) *Disclosure of compensation paid or promised to bankruptcy petition preparer.* Before a petition is filed, every bankruptcy petition preparer for a debtor shall deliver to the debtor, the declaration under penalty of perjury required by § 110(h)(2). The declaration shall disclose any fee, and the source of any fee, received from or on behalf of the debtor within 12 months of the filing of the case and all unpaid fees charged to the debtor. The declaration shall also describe the services performed and documents prepared or caused to be prepared by the bankruptcy petition preparer. The declaration shall be filed with the petition. The petition preparer shall file a supplemental statement within 14 days after any payment or agreement not previously disclosed.

Fed. R. Bankr. P. 2016

C. CASE EXAMPLES

1. *Lamie v. United States Trustee*, 540 U.S. 526 (2004).

With respect to Chapter 7, if debtor's counsel seeks to be paid from the bankruptcy estate, then its counsel must be employed by the bankruptcy estate and such employment must be approved by the court. In *Lamie*, the Supreme Court held:

> Under the Code's plain language, § 330(a)(1) does not authorize compensation awards to debtors' attorneys from estate funds, unless they are employed as authorized by § 327. If the attorney is to be paid from estate funds under § 330(a)(1) in a Chapter 7 case, he must be employed by the trustee and approved by the court.

Lamie, 540 U.S. at 526.

2. *Baker Botts L.L.P. v. Asarco LLC*, 135 S.Ct. 2158 (2015).

Chapter 11 Debtor's counsel, among other things, prosecuted fraudulent transfer action against the Debtor's parent company and obtained a judgment against between $7 and $10 billion. The judgment resulted in a successful reorganization and the Debtor emerged from bankruptcy with little debt and $1.4 billion in cash. Debtor's counsel sought compensation in excess of $120 million. In addition to being awarded their fees, the bankruptcy court also awarded counsel over $5 million for the time spent litigating their fees. The Supreme Court affirmed the ruling of the Fifth Circuit Court of appeals and held that 11 U.S.C. § 330(a) does not permit bankruptcy courts to award fees to professionals employed under 11 U.S.C. § 327(e) for defending their fee applications.

3. *Redmond v. Lentz & Clark, P.A. (In re Wagers)*, 514 F.3d 1021 (10th Cir. 2007).

In *Wagers*, the debtors hired the law firm to represent them with respect to their financial situation. As a retainer, the debtors executed an assignment of their 2003 tax refunds, which amounted to $50,000. The debtor's incurred approximately $13,000 in post-petition legal fees. The law firm was never formally employed by the trustee or the bankruptcy estate. The trustee took the position that despite the law firm's assignment that the law firm was not entitled to any portion of the tax refund. *Wagers*, 514 F.3d at 1023-24. The Tenth Circuit, reversing the bankruptcy court, agreed:

> This Court shares the Bankruptcy Court's concerns regarding adequate payment of Debtors' counsel. However, we do not agree that the retainers in this case can properly be considered to be outside of the Debtors' estate. Whereas the Bankruptcy Court found that the Debtors retained only a contingent, reversionary interest in the retainer, we find it more likely that the Kansas Supreme Court would hold that it is the Firm that holds only a contingent interest in the funds. In any event, even a contingent, reversionary interest is included in a debtor's estate under § 541. Therefore, since the assigned tax refunds were property of the Debtors' estate, and the Firm was not employed by the Trustee pursuant to § 327, our decision is dictated by the United States Supreme Court's opinion in *Lamie*. We hold that the Firm may not use pre-petition funds to pay its post-petition fees under the circumstances of this case. The Bankruptcy Court's decision to the contrary is reversed.

Id. at 1029-30.

4. *Stalnaker v. DLC, Ltd. (In re DLC Ltd.)*, 295 B.R. 593 (8th Cir. B.A.P. 2003), *affirmed by* 376 F.3d 819 (8th Cir. 2004).

Debtor filed for Chapter 7 bankruptcy and a trustee was appointed. The trustee retained counsel to avoid certain purported fraudulent transfers to an affiliated insider.

Approximately two years later, the target of the fraudulent transfer essentially settled the claims of the unsecured creditors. The bankruptcy court went ahead and held a trial and found the transfers the trustee was seeking were fraudulent transfers. The bankruptcy court granted the attorneys' fees in the amount of $58,280.25.

The debtor appealed to the Bankruptcy Appellate Panel challenging the reasonableness of the attorney fees awarded by the bankruptcy court. The Bankruptcy Appellate Panel affirmed the bankruptcy court applying the following standard:

> In calculating the appropriate compensation, the lodestar approach, including the possibility of adjustments in rare and exceptional circumstances, is an appropriate method to use in calculating reasonable compensation under § 330. *Chamberlain v. Kula (In re Kula)*, 213 B.R. 729, 736 (8th Cir. BAP 1997). The lodestar method is calculated as the number of hours reasonably expended multiplied by a reasonable hourly rate. *Id*. Determinations as to necessity, reasonableness, etc., involve questions of fact. The bankruptcy court's decision to award fees is reviewed for an abuse of discretion*. Grunewaldt v. Mut. Life Ins. Co. (In re Coones Ranch, Inc.)*, 7 F.3d 740, 744 (8th Cir.1993). Moreover, judges are justified in relying on their own knowledge of customary rates and experience concerning reasonable and proper fees, without the need for independent evidence. *Bachman v. Pelofsky (In re Peterson)*, 251 B.R. 359, 365 (8th Cir. BAP 2000).

Stalnaker, 295 B.R. at 608. Further, the Bankruptcy Appellate Panel rejected the appellant's argument that the attorneys' services must benefit the bankruptcy estate before they could be compensated. *Id*. The Eighth Circuit affirmed finding, in part:

> Compensation may be reasonable though the trustee's services do not benefit the estate. The determination of reasonable compensation under section 330 includes accounting for factors such as hours reasonably expended, competitive hourly rates, and the necessity and benefit of the work to the completion of a case (not simply to the settlement of unsecured creditors' claims). 11 U.S.C. § 330(a)(3).

Stalnaker, 376 F.3d at 825.

5. ***Mkt. Ctr. E. Retail Prop. v. Lurie (In re Mkt. Ctr. E. Retail Prop.)*, 730 F.3d 1239 (10th Cir. 2013).**

The debtor was a corporation that filed for Chapter 11 bankruptcy. Prior to filing for bankruptcy, the debtor had entered into a fee arrangement with an attorney to prosecute several claims the debtor had for breach of contract among other things. The claims were being brought on a contingency fee basis. The parties both believed that the settlement amount that could be reasonably expected was $200,000. Debtor did not initially notify the attorney of its bankruptcy filing, but later employed the attorney on the pre-bankruptcy terms. There were two objections to the employment application which were resolved, but a final order was not submitted to the bankruptcy court.

The debtor negotiated a settlement with the defendant and withdrew its application to employ the attorney. The attorney responded raising several allegations of the debtor's good faith. The attorney also requested that it be given the opportunity to file a fee application and the proceeds be paid out of the negotiated settlement. The bankruptcy court found that debtor was acting in bad faith with respect to the employment application. A stipulated order granting the employment was soon entered reserving certain issues with respect to the reasonableness of the retention terms to be heard with a fee application.

The attorney filed the fee application. He sought compensation in excess of $1,470,000, which represented the fifteen percent contingency, plus his hourly fees and expenses. Debtor objected on the basis that the attorney was only entitled to $28,000 applying a lodestar approach. The bankruptcy court allowed for the fifteen percent contingency, but based it upon the improvement of position of the debtor rather than the ultimate sale price. The bankruptcy court awarded fees in the amount of $350,752.06. Of that amount, $337,500 derived from the contingency aspect of the retention. The debtor appealed to the Tenth Circuit Bankruptcy Appellate Panel.

The Tenth Circuit Bankruptcy Appellate Panel affirmed the bankruptcy court. *See In re Market Center East Retail Property, Inc.*, 469 B.R. 44 (10th Cir. B.A.P. 2012). The Bankruptcy Appellate Panel rejected that the only factors that the bankruptcy court can look at are those contained in 11 U.S.C. § 330(a)(3), specifically the hours spent and hourly rates. Further, while the Bankruptcy Appellate Panel found the lodestar analysis may be relevant it is not exclusive or controlling. The Bankruptcy Appellate Panel also rejected that fee enhancements are not *per se* impermissible especially where counsel achieves exceptional results.

On appeal, the Tenth Circuit reversed the bankruptcy court and the BAP and remanded the case back to the bankruptcy court. The Tenth Circuit first found that the bankruptcy court erred as a matter of law:

> We have recognized that "bankruptcy courts have wide discretion in awarding compensation to attorneys, trustees, and professionals so long as it is reasonable." *In re Commercial Fin. Servs.*, 427 F.3d at 810. The bankruptcy court must nonetheless properly consider the § 330(a)(3) and Johnson factors in evaluating whether the compensation is reasonable. Thus, the bankruptcy court erred in holding that it had discretion to ignore any of the § 330(a)(3) factors. *In re Market Center I*, 448 B.R. at 62. A bankruptcy court has discretion in determining how much weight to assign each factor and in determining the reasonableness of a fee, but this discretion does not extend to disregarding factors prescribed by statute. Section 330 and our case law instruct bankruptcy courts to consider the § 330(a)(3) factors as well as relevant Johnson factors.

730 F.3d at 1250. The Tenth Circuit also found that the bankruptcy court erred in applying Section 330(a)(3)(A):

> The problem with the bankruptcy court's § 330(a)(3)(A) analysis is that the two issues that it considered—the big risk/big reward argument, as well as the reasonableness of the parties' pre-bankruptcy compensation agreement——do not fall under the § 330(a)(3)(A) factor, "the time spent on such services." As we stated in *In re Commercial Financial Services*, "under 11 U.S.C. § 330(a)(3), a bankruptcy court is directed to consider at least five factors, among which four either explicitly or implicitly direct a bankruptcy court to examine the amount of time spent on a project." 427 F.3d at 811-12. It is unclear how an argument of "big risk/big reward" or reasonableness of the parties' pre-bankruptcy compensation agreement is related to "the time spent on such services." A straightforward application of the § 330(a)(3)(A) factor would weigh against a large attorney's fee, as Lurie only spent approximately forty hours on the case. In fact, the bankruptcy court found that the first Johnson factor, the time and labor required, weighs in favor of Market Center because "the relatively small amount of time expended by [Lurie] . . . weighs against the size of the award." *In re Market Center I*, 448 B.R. at 66. *See also In re Busy Beaver Bldg. Ctrs., Inc.*, 19 F.3d 833, 849 (3d Cir. 1994) ("The remaining § 330(a) factor—the time spent on such services—is a sibling of the lodestar approach's reasonable

730 F.3d at 1251.

As referenced in *Market Center,* the relevant lodestar approach used in the Tenth Circuit was originally set forth in *Johnson v. Georgia Highway Express, Inc.*. *See Market Center East Retail Property, Inc.*, 469 B.R. at 52 (citing *In re Commercial Fin. Servs., Inc.*, 298 B.R. 733, 747–48 (10th Cir. BAP 2003), *affirmed by* 427 F.3d 804 (10th Cir.2005)). "The 'Johnson factors,' which were developed in a civil rights case, are: 1) time and labor required; 2) novelty and difficulty of the issues; 3) skill required to render proper legal services; 4) preclusion of other employment; 5) customary fee; 6) whether the fee is fixed or contingent; 7) time limits imposed; 8) amount involved and results obtained; 9) attorney's experience, reputation, and ability; 10) undesirability of the case; 11) length and nature of the attorney/client relationship; and 12) awards in similar cases." *Id*. (citing *Johnson v. Ga. Highway Express, Inc.*, 488 F.2d 714, 717–19 (5th Cir.1974), *abrogated in part by Blanchard v. Bergeron*, 489 U.S. 87, 93, 109 S.Ct. 939, 103 L.Ed.2d 67 (1989)).

6. *In re Miller Automotive Group, Inc.*, 521 B.R. 323 (Bankr. W.D. Mo. 2014)

The debtor in *Miller* held a franchise with Chrysler Corporation. It filed a voluntary petition for Chapter 11 relief. Days after filing of the petition, counsel filed its Rule 2016 disclosure of compensation indicating that counsel had been paid a $8,000 retainer. The retainer was not paid by the debtor, but by an equity owner of the debtor. While this was indicated in the Statement of Financial Affairs, it was not included in the 2016 disclosure.

Debtor's counsel filed a Chapter 11 Plan, but it was rejected for failure to file a disclosure statement. Additionally, two of the debtor's largest creditors filed for relief from the automatic stay to terminate certain sales and service agreements. Prior to such motions being heard, the debtor sought to dismiss the case, which was granted. The United States Trustee filed a motion to reopen to seek a determination of fees and debtor's counsel filed fee application thereafter.

In addition to the thorough discussion regarding reasonableness of debtor's counsel fees and ultimately requiring debtor's counsel to disgorge all fees received, the Court also took up whether the information surrounding the retainer had been appropriately disclosed. The court found that debtor's counsel failed to appropriately disclose the retainer. Moreover, the fact that such information was in the Statement of Financial Affair was not sufficient, in part, because such document was filed two weeks after the 2016 disclosure and after the court had considered the initial employment application.

In summarizing debtor's counsel overall performance, the court stated:

> To borrow the words of another court, "were there ever at time to use 'fail' as the contemporary vernacular permits, it is now, and in reference to this deplorable display of legal representation: it was an epic fail."

Id. at 337 (quoting *In re Spickelmier*, 469 B.R. 903, 906 (Bankr. D. Nev. 2012)).

Finally, in addition to the disallowance and disgorgement of fees, the court went through debtor's counsel checkered past before various courts. *Id.* at 335-36. Ultimately, using authority under Section 105 and Rule 9011, the Bankruptcy Court suspended debtor's counsel indefinitely from the privilege to practice before the United States Bankruptcy Court for the Western District of Missouri.

7. *In re Satnam Lodging, LLC*, 2013 WL 3776326 (Bankr. W.D. Mo. 2013)

In this Chapter 11 case, debtor's counsel operated a hotel. Prior to filing the Chapter 11 case at issue, debtor had previously filed a case which was voluntarily dismissed. In the prior case, debtor's counsel represented in her 2016 statement, the statement of financial affairs, and the employment application, that Debtor had paid counsel a $3,000 retainer prior to filing the case. Debtor's counsel never filed a fee application or supplemented her disclosures prior to dismissal.

In the case at issue, debtor's counsel filed disclosures indicating that she had agreed to accept $0.00 for legal services and that $0.00 had been paid prior to the filing. Debtor's statement of financial affairs similarly disclosed that no monies had been paid for consultation concerning bankruptcy law or preparation of the petition. In the employment application, the Debtor represented that debtor's counsel had not received a retainer.

At a telephonic hearing, the United States Trustee and another creditor raised concerns that Debtor had transferred monies to its affiliates. Following the hearing, the court ordered debtor's counsel to file the necessary applications and disclosures. Debtor's counsel did not comply with this Order until a show cause was issued. Debtor's counsel ultimately filed an amended disclosure reflecting that counsel had received $5,000 in connection with filing the case. The source of the compensation was from a principal of the debtor. The court ultimately ordered debtor's counsel to disgorge the $5,000 finding that the nondisclosure was intentional.

The United States Trustee then filed a motion to disgorge all fees from debtor's counsel. It was disclosed that debtor's counsel had received approximately $31,285 from the debtor and from the debtor's affiliates prior to and after the case was filed. While the court acknowledged that accepting payment from a third-party is not a *per se* disqualification, it found that it must still evaluate whether such payment disqualifies debtor's counsel from the representation. The Court found debtor's counsel nondisclosure troubling and ultimately required disgorgement of $16,033.

III. SOLICITATION AND REFERRALS

A. APPLICABLE RULES OF PROFESSIONAL CONDUCT

1. ABA Model Rule 7.1. Communications Concerning A Lawyer's Services

A lawyer shall not make a false or misleading communication about the lawyer or the lawyer's services. A communication is false or misleading if it contains a material misrepresentation of fact or law, or omits a fact necessary to make the statement considered as a whole not materially misleading.

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2. Missouri Rule 4-7.1. Communications Concerning A Lawyer's Services[3]

A lawyer shall not make a false or misleading communication about the lawyer or the lawyer's services.

A communication is false if it contains a material misrepresentation of fact or law.

A communication is misleading if it:

(a) omits a fact as a result of which the statement considered as a whole is materially misleading;

[3] The Missouri Rules of Professional Conduct can be found at http://www.courts.mo.gov/page.jsp?id=707

(b) is likely to create an unjustified expectation about results the lawyer can achieve;

(c) proclaims results obtained on behalf of clients, such as the amount of a damage award or the lawyer's record in obtaining favorable verdicts or settlements, without stating that past results afford no guarantee of future results and that every case is different and must be judged on its own merits;

(d) states or implies that the lawyer can achieve results by means that violate the Rules of Professional Conduct or other law;

(e) compares the quality of a lawyer's or a law firm's services with other lawyers' services, unless the comparison can be factually substantiated;

(f) advertises for a specific type of case concerning which the lawyer has neither experience nor competence;

(g) indicates an area of practice in which the lawyer routinely refers matters to other lawyers, without conspicuous identification of such fact;

(h) contains any paid testimonial about or endorsement of the lawyer, without conspicuous identification of the fact that payment has been made for the testimonial or endorsement;

(i) contains any simulated portrayal of a lawyer, client, victim, scene, or event without conspicuous identification of the fact that it is a simulation;

(j) provides an office address for an office staffed only part-time or by appointment only, without conspicuous identification of such fact; or

(k) states that legal services are available on a contingent or no-recovery-no-fee basis without stating conspicuously that the client may be responsible for costs or expenses, if that is the case.

The presumptions that statements are misleading contained in Rule 4-7.1(c), (g), (h), and (k) shall not apply to a not-for-profit organization funded in whole or in part by the Legal Services Corporation established by 42 U.S.C section 2996(b) or to pro bono services provided free of charge by a not-for-profit organization, a court-annexed program, a bar association, or an accredited law school.

V.A.M.R., Rules of Prof. Conduct. Rule 4-7.1.[4]

[4] The Missouri Rules of Professional Conduct can be found at http://www.courts.mo.gov/page.jsp?id=707

3. ABA Model Rule 7.2: Advertising

(a) Subject to the requirements of Rules 7.1 and 7.3, a lawyer may advertise services through written, recorded or electronic communication, including public media.

(b) A lawyer shall not give anything of value to a person for recommending the lawyer's services except that a lawyer may

(1) pay the reasonable costs of advertisements or communications permitted by this Rule;

(2) pay the usual charges of a legal service plan or a not-for-profit or qualified lawyer referral service. A qualified lawyer referral service is a lawyer referral service that has been approved by an appropriate regulatory authority;

(3) pay for a law practice in accordance with Rule 1.17; and

(4) refer clients to another lawyer or a nonlawyer professional pursuant to an agreement not otherwise prohibited under these Rules that provides for the other person to refer clients or customers to the lawyer, if

(i) the reciprocal referral agreement is not exclusive, and

(ii) the client is informed of the existence and nature of the agreement.

(c) Any communication made pursuant to this rule shall include the name and office address of at least one lawyer or law firm responsible for its content.

4. Missouri Rule 4-7.2. Advertising

(a) Subject to the requirements of Rule 4-7.1, a lawyer may advertise services through public media, such as a telephone directory, legal directory, newspaper or other periodical, outdoor advertising, radio, or television, or through direct mail advertising distributed generally to persons not known to need legal services of the kind provided by the lawyer in a particular matter.

(b) A copy or recording of an advertisement or written communication shall be kept for two years after its last dissemination along with a record of when and where it was used. The record shall include the name of at least one lawyer responsible for its content unless the advertisement or written communication itself contains the name of at least one lawyer responsible for its content.

(c) A lawyer shall not give anything of value to a person for recommending the lawyer's services, except that:

(1) a lawyer may pay the reasonable cost of advertising or written communication permitted by this Rule 4-7.2;

(2) a lawyer may pay the reasonable cost of advertising, written communication, or other notification required in connection with the sale of a law practice as permitted by Rule 4-1.17; and

(3) a lawyer may pay the usual charges of a qualified lawyer referral service registered under Rule 4-9.1 or other not-for-profit legal services organization.

(d) A lawyer may not, directly or indirectly, pay all or a part of the cost of an advertisement in the public media unless such advertisement discloses the name and address of the financing lawyer, the relationship between the advertising lawyer and the financing lawyer, and whether the advertising lawyer is likely to refer cases received through the advertisement to the financing lawyer. Similarly, in any communications such as television, radio, or other electronic programs purporting to give the public legal advice or legal information, for which programs the broadcaster receives any remuneration or other consideration, directly or indirectly, from the lawyer who appears on those programs, the lawyer shall conspicuously disclose to the public the fact that the broadcaster has been paid or receives consideration from the lawyer appearing on the program.

(e) A lawyer or law firm shall not advertise the existence of any office other than the principal office unless:

(1) that other office is staffed by a lawyer at least three days a week, or

(2) the advertisement states:

(A) the days and times during which a lawyer will be present at that office, or

(B) that meetings with lawyers will be by appointment only.

(f) Any advertisement or communication made pursuant to this Rule 4-7.2, other than written solicitations governed by the disclosure rules of Rule 4-7.3(b), shall contain the following conspicuous disclosure:

"The choice of a lawyer is an important decision and should not be based solely upon advertisements."

"Conspicuous" means that the required disclosure must be of such size, color, contrast, location, duration, cadence, or audibility that an ordinary person can readily notice, read, hear, or understand it.

(g) The disclosures required by Rule 4-7.2(e) and (f) need not be made if the information communicated is limited to the following:

(1) the name of the law firm and the names of lawyers in the firm;

(2) one or more fields of law in which the lawyer or law firm practices;

(3) the date and place of admission to the bar of state and federal courts; and

(4) the address, including e-mail and web site address, telephone number, and office hours.

(h) Any words or statements required by Rules 4-7.1, 4-7.2, or 4-7.3 to appear in an advertisement or direct mail communication must appear in the same language in a which the advertisement or direct mail solicitation appears. If more than one language is used in an advertisement or direct mail communication, any words or statements required by Rules 4-7.1 to 4-7.6 must appear in each language used in the advertisement or direct mail communication.

(i) The provisions of Rule 4-7.2 shall not apply to services provided by a not-for-profit organization funded in whole or in part by the Legal Services Corporation established by 42 U.S.C. section 2996(b) or to pro bono services provided free of charge by a not-for-profit organization, a court-annexed program, a bar association, or an accredited law school.

The provisions of Rule 4-7.2 shall not apply to law firms or lawyers who promote, support or publicize through advertising that substantially and predominantly features any of the following: legal services corporation; community or other non-profit organization; recognized community events or celebrations; institutions; entities; or individuals other than themselves.

V.A.M.R., Rules of Prof. Conduct. Rule 4-7.2.

5. ABA Model Rule 7.3 Solicitation of Clients

(a) A lawyer shall not by in‑person, live telephone or real-time electronic contact solicit professional employment when a significant motive for the lawyer's doing so is the lawyer's pecuniary gain, unless the person contacted:

(1) is a lawyer; or

(2) has a family, close personal, or prior professional relationship with the lawyer.

(b) A lawyer shall not solicit professional employment by written, recorded or electronic communication or by in‑person, telephone or real-time electronic contact even when not otherwise prohibited by paragraph (a), if:

(1) the target of the solicitation has made known to the lawyer a desire not to be solicited by the lawyer; or

(2) the solicitation involves coercion, duress or harassment.

(c) Every written, recorded or electronic communication from a lawyer soliciting professional employment from anyone known to be in need of legal services in a particular matter shall include the words "Advertising Material" on the outside envelope, if any, and at the beginning and ending of any recorded or electronic communication, unless the recipient of the communication is a person specified in paragraphs (a)(1) or (a)(2).

(d) Notwithstanding the prohibitions in paragraph (a), a lawyer may participate with a prepaid or group legal service plan operated by an organization not owned or directed by the lawyer that uses in-person or telephone contact to solicit memberships or subscriptions for the plan from persons who are not known to need legal services in a particular matter covered by the plan.

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6. Missouri Rule 4-7.3. Direct Contact with Prospective Clients

This Rule 4-7.3 applies to in-person and written solicitations by a lawyer with persons known to need legal services of the kind provided by the lawyer in a particular matter for the purpose of obtaining professional employment.

(a) In-person solicitation. A lawyer may not initiate the in-person, telephone, or real time electronic solicitation of legal business under any circumstance, other than with an existing or former client, lawyer, close friend, or relative.

(b) Written Solicitation. A lawyer may initiate written solicitations to an existing or former client, lawyer, friend, or relative without complying with the requirements of this Rule 4-7.3(b). Written solicitations to others are subject to the following requirements:

(1) any written solicitation by mail shall be plainly marked “ADVERTISEMENT” on the face of the envelope and all written solicitations shall be plainly marked “ADVERTISEMENT” at the top of the first page in type at least as large as the largest written type used in the written solicitation;

(2) the lawyer shall retain a copy of each such written solicitation for two years. If written identical solicitations are sent to two or more prospective clients, the lawyer may comply with this requirement by retaining a single copy together with a list of the names and addresses of persons to whom the written solicitation was sent;

(3) each written solicitation must include the following:

> “Disregard this solicitation if you have already engaged a lawyer in connection with the legal matter referred to in this solicitation. You may wish to consult your lawyer or another lawyer instead of me (us). The exact nature of your legal situation will depend on many facts not known to me (us) at this time. You should understand that the advice and information in this

solicitation is general and that your own situation may vary. This statement is required by rule of the Supreme Court of Missouri;"

(4) written solicitations mailed to prospective clients shall be sent only by regular United States mail, not registered mail or other forms of restricted or certified delivery;

(5) written solicitations mailed to prospective clients shall not be made to resemble legal pleadings or other legal documents;

(6) any written solicitation prompted by a specific occurrence involving or affecting the intended recipient of the solicitation or family member shall disclose how the lawyer obtained the information prompting the solicitation;

(7) a written solicitation seeking employment by a specific prospective client in a specific matter shall not reveal on the envelope or on the outside of a self-mailing brochure or pamphlet the nature of the client's legal problem;

(8) if a lawyer knows that a lawyer other than the lawyer whose name or signature appears on the solicitation will actually handle the case or matter or that the case or matter will be referred to another lawyer or law firm, any written solicitation concerning a specific matter shall include a statement so advising the potential client; and

(9) a lawyer shall not send a written solicitation regarding a specific matter if the lawyer knows or reasonably should know that the person to whom the solicitation is directed is represented by a lawyer in the matter.

(c) A lawyer shall not send, nor knowingly permit to be sent, on behalf of the lawyer, the lawyer's firm, the lawyer's partner, an associate, or any other lawyer affiliated with the lawyer or the lawyer's firm a written solicitation to any prospective client for the purpose of obtaining professional employment if:

(1) it has been made known to the lawyer that the person does not want to receive such solicitations from the lawyer;

(2) the written solicitation involves coercion, duress, fraud, overreaching, harassment, intimidation, or undue influence;

(3) the written solicitation contains a false, fraudulent, misleading, or deceptive statement or claim or makes claims as to the comparative quality of legal services, unless the comparison can be factually substantiated, or asserts opinions about the liability of the defendant or offers assurances of client satisfaction;

(4) the written solicitation concerns an action for personal injury or wrongful death or otherwise relates to an accident or disaster involving the person solicited or a relative of that person if the accident or disaster occurred less than 30 days prior to the solicitation or if the lawyer knows or reasonably should know that the physical,

emotional, or mental state of the person solicited makes it unlikely that the person would exercise reasonable judgment in employing a lawyer; or

(5) the written solicitation vilifies, denounces or disparages any other potential party.

(d) The provisions of Rule 4-7.3 shall not apply to services provided by a not-for-profit organization funded in whole or in part by the Legal Services Corporation established by 42 U.S.C. Section 2996(b) or to pro bono services provided free of charge by a not-for-profit organization, a court annexed program, a bar association, or an accredited law school.

V.A.M.R., Rules of Prof. Conduct. Rule 4-7.3.

7. ABA Model Rule 7.4. Communication of Fields of Practice & Specialization

(a) A lawyer may communicate the fact that the lawyer does or does not practice in particular fields of law.

(b) A lawyer admitted to engage in patent practice before the United States Patent and Trademark Office may use the designation "Patent Attorney" or a substantially similar designation.

(c) A lawyer engaged in Admiralty practice may use the designation "Admiralty," "Proctor in Admiralty" or a substantially similar designation.

(d) A lawyer shall not state or imply that a lawyer is certified as a specialist in a particular field of law, unless:

(1) the lawyer has been certified as a specialist by an organization that has been approved by an appropriate state authority or that has been accredited by the American Bar Association; and

(2) the name of the certifying organization is clearly identified in the communication.

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8. Missouri Rule 4-7.4. Communication of Fields of Practice and Specialization

A lawyer may communicate the fact that the lawyer does or does not practice in particular fields of law. Any such communication shall conform to the requirements of Rule 4-7.1. Except as provided in Rule 4-7.4(a) and (b), a lawyer shall not state or imply that the lawyer is a specialist unless the communication contains a disclaimer that neither the Supreme Court of Missouri nor The Missouri Bar reviews or approves certifying organizations or specialist designations.

(a) A lawyer admitted to engage in patent practice before the United States Patent and Trademark Office may use the designation "patent attorney" or a substantially similar designation;

(b) A lawyer engaged in admiralty practice may use the designation "admiralty," "proctor in admiralty" or a substantially similar designation.

V.A.M.R., Rules of Prof. Conduct. Rule 4-7.4.

9. ABA Model Rule 7.5. Firm Names and Letterheads

(a) A lawyer shall not use a firm name, letterhead or other professional designation that violates Rule 7.1. A trade name may be used by a lawyer in private practice if it does not imply a connection with a government agency or with a public or charitable legal services organization and is not otherwise in violation of Rule 7.1.

(b) A law firm with offices in more than one jurisdiction may use the same name or other professional designation in each jurisdiction, but identification of the lawyers in an office of the firm shall indicate the jurisdictional limitations on those not licensed to practice in the jurisdiction where the office is located.

(c) The name of a lawyer holding a public office shall not be used in the name of a law firm, or in communications on its behalf, during any substantial period in which the lawyer is not actively and regularly practicing with the firm.

(d) Lawyers may state or imply that they practice in a partnership or other organization only when that is the fact.

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10. Missouri Rule 4-7.5. Firm Names and Letterheads

(a) A lawyer shall not use a firm name, letterhead, or other professional designation that violates Rule 4-7.1. A trade name may be used by a lawyer in private practice if it does not imply a connection with a government agency or with a public or charitable legal services organization and is not otherwise in violation of Rule 4-7.1.

(b) A law firm with offices in more than one jurisdiction may use the same name or other professional designation in each jurisdiction, but identification of the lawyers in an office of the firm shall indicate the jurisdictional limitations on those not licensed to practice in the jurisdiction where the office is located.

(c) The name of a lawyer holding a public office shall not be used in the name of a law firm, or in communications on its behalf, during any substantial period in which the lawyer is not actively and regularly practicing with the firm.

(d) Lawyers may state or imply that they practice in a partnership or other organization only when that is the fact.

V.A.M.R., Rules of Prof. Conduct. Rule 4-7.5.

11. Missouri Rule 4-9.1. Lawyer Referral and Information Systems

(a) The operation of this Rule 4-9.1 and compliance with its provisions shall be supervised by the chief disciplinary counsel. The chief disciplinary counsel shall develop and promulgate regulations, procedures, and forms not inconsistent with this Rule 4-9.1, including the amount of the fee to register a qualified service, subject to approval by this Court.

(b) Lawyers eligible to practice in this state may participate in a service that refers them to prospective clients, but only if the service is a qualified service because it conforms to this Rule 4-9.1.

(c) A qualified service shall be operated in the public interest for the purpose of referring prospective clients to lawyers, pro bono and public service legal programs, and government, consumer, or other agencies that can provide the assistance the clients need in light of their financial circumstances, spoken language, any disability, geographical convenience, and the nature and complexity of their problems.

(d) Only a qualified service may call itself a lawyer referral service or operate for a direct or indirect purpose of referring potential clients to particular lawyers, whether or not the term 'referral service' is used.

(e) A qualified service must be open to all lawyers licensed to practice in this state who:

(1) maintain an office within the geographical area served,

(2) pay reasonable fees established by the service, and

(3) maintain in force a policy of errors and omissions insurance in an amount at least equal to the minimum established by the chief disciplinary counsel.

A qualified service shall establish and publish a procedure for admitting, suspending, or removing lawyers from its roll of panelists.

(f) No fee generating referral may be made to any lawyer who has an ownership interest in, or who operates or is employed by, a qualified service or who is associated with a law firm that has an ownership interest in, or operates or is employed by, a qualified service.

(g) A qualified service shall periodically survey client satisfaction with its operations and shall investigate and take appropriate action with respect to client complaints against panelists, the service, and its employees.

(h) A qualified service may establish specific subject matter panels, including moderate and no fee panels, foreign language panels, alternative dispute resolution panels, and other special panels that respond to the referral needs of the consumer public, eligibility for which shall be determined on the basis of experience and other substantial objectively determinable criteria.

(i) A qualified service shall:

(1) register with the chief disciplinary counsel and demonstrate its compliance with this Rule 4-9.1 before commencing to operate;

(2) update the materials filed with the chief disciplinary counsel within 30 days of any material change; and

(3) on or before June 30 annually, file with the chief disciplinary counsel a report of its operations and finances during the previous twelve months demonstrating its continued compliance with this Rule 4-9.1.

(j) This Rule 4-9.1 does not apply to:

(1) a group or prepaid legal plan, whether operated by a union trust, mutual benefit or aid association, corporation, or other entity or person that provides unlimited or a specified amount of telephone advice or personal communication at no charge to the members or beneficiaries, other than a periodic membership or beneficiary fee, and that furnishes or pays for legal services to its beneficiaries;

(2) a plan of prepaid legal services insurance authorized to operate in this state;

(3) individual lawyer-to-lawyer referrals;

(4) lawyers jointly advertising their own services in a manner that discloses that such advertising is solely to solicit clients for themselves;

(5) any pro bono legal assistance program that does not accept any fee from clients for referrals; or

(6) any organization maintaining a 26 USC 501(c)(3) exemption that maintains a referral list only incident to its other activities.

(k) A disclosure of information to a lawyer referral service for the purpose of seeking legal assistance or for purposes of complying with the survey under Rule 4-9.1(g) shall be deemed a privileged lawyer-client communication.

(l) The chief disciplinary counsel may deny, suspend, or cancel any registration upon making a finding of a material violation of any provisions of this Rule 4-9.1. Any person who is substantially and individually aggrieved by the action of the chief disciplinary counsel may, within 30 days of receiving notice of the action, petition this Court for review of the action of the chief disciplinary counsel. This Court may direct that the issues raised in the petition be briefed and argued as though a petition for an original remedial writ has been sustained. This Court may sustain, modify, or vacate the action of the chief disciplinary counsel or dismiss the petition.

(m) Any person violating the provisions of this Rule 4-9.1 shall be deemed to be engaged in the unauthorized practice of law.

V.A.M.R., Rules of Prof. Conduct. Rule 4-9.1.

B. CASE EXAMPLES

1. *In re Universal Building Products*, 486 B.R. 650 (Bankr. D. Del. 2010)

The day that debtors filed their bankruptcy petition, attorneys sent copies of the petition and the list of the thirty largest creditors to an intermediary who had experience dealing with Asian creditors in bankruptcy cases. The intermediary did not have an existing relationship with any of the Asian creditors, but worked to contact them to see if he could become their proxy at the committee formation meeting. During the time that the intermediary was contacting creditors, he was in communication with two law firms to report on his progress in obtaining proxies. An attorney at one of the firms helped the intermediary find contact information for some of the creditors.

The intermediary also asked the two law firms for legal advice for the creditors, which one of the law firms provided. The intermediary became the proxy for one of the creditors and helped arrange a proxy for another creditor. The intermediary voted on the counsel for the committee, and the two law firms that the intermediary had been communicating with were chosen as counsel. The intermediary was then hired as a translator, and the intermediary found another attorney to act as proxy for the creditor.

The debtors argue that these attorneys should not be the committee's counsel. The bankruptcy court agreed, finding that the attorneys violated Rule 7.3 by "cold calling" creditors through an intermediary in order to be voted as counsel for the committee. The court noted that it did not take issue with the law firms contacting individuals that they already a professional relationship with, but that there was a problem with soliciting creditors that they, or their intermediary, had not previously represented.

2. *In the Matter of Horace Frazier Hunter*, 744 S.E.2d 611 (Va. 2013).

In March 2011, the Virginia State Bar issued a charge of misconduct against an attorney alleging that his blog disclosed information regarding his clients' cases which would either be embarrassing or detrimental to his client. It appears that the information that was being blogged about may have been publically available. In October, the Virginia State Bar required that he add a disclaimer warning that results could vary in other cases. It also issued a public admonition. The attorney appealed. In June 2012, a three-judge panel upheld that the attorney violated certain advertising rules by not having the disclaimer, but overturned the finding that the attorney had violated Rule 1.6 on First Amendment grounds.

The attorney appealed to the Virginia Supreme Court. In a detailed opinion, the Virginia Supreme Court found that the blog posts were commercial speech, have the potential to be misleading, that the required disclosures by the Virginia State Bar advanced a government interest to protect the public, and that the disclaimer requirements of Rules 7.1 and 7.2 were not overly restrictive. Accordingly, such rules did not violate the First Amendment. However, the disclaimer approved by the panel did not fully comply with Rule 7.2(a)(3). The Virginia Supreme Court also affirmed the panel that the attorney did not violate Rule 1.6 on account of the First Amendment.

IV. KEEPING CLIENT CONFIDENCES AND WITHDRAWING

A. APPLICABLE RULES OF PROFESSIONAL CONDUCT

1. ABA Model Rule 1.6. Confidentiality of Information

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to prevent reasonably certain death or substantial bodily harm;

(2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

(3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

(4) to secure legal advice about the lawyer's compliance with these Rules;

(5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client;

(6) to comply with other law or a court order; or

(7) to detect and resolve conflicts of interest arising from the lawyer's change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client.

(c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.

ABA Model Rule 1.6. ©2016 by the American Bar Association.

2. Missouri Rule 4-1.6. Confidentiality of Information

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation, or the disclosure is permitted by Rule 4-1.6(b)

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to prevent death or substantial bodily harm that is reasonably certain to occur;

(2) to secure legal advice about the lawyer's compliance with these Rules;

(3) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or

(4) to comply with other law or a court order.

V.A.M.R., Rules of Prof. Conduct. Rule 4-1.6.

3. ABA Model Rule 1.16. Declining or Terminating Representation

(a) Except as stated in paragraph (c), a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if:

(1) the representation will result in violation of the rules of professional conduct or other law;

(2) the lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client; or

(3) the lawyer is discharged.

(b) Except as stated in paragraph (c), a lawyer may withdraw from representing a client if:

(1) withdrawal can be accomplished without material adverse effect on the interests of the client;

(2) the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent;

(3) the client has used the lawyer's services to perpetrate a crime or fraud;

(4) the client insists upon taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement;

(5) the client fails substantially to fulfill an obligation to the lawyer regarding the lawyer's services and has been given reasonable warning that the lawyer will withdraw unless the obligation is fulfilled;

(6) the representation will result in an unreasonable financial burden on the lawyer or has been rendered unreasonably difficult by the client; or

(7) other good cause for withdrawal exists.

(c) A lawyer must comply with applicable law requiring notice to or permission of a tribunal when terminating a representation. When ordered to do so by a tribunal, a lawyer shall continue representation notwithstanding good cause for terminating the representation.

(d) Upon termination of representation, a lawyer shall take steps to the extent reasonably practicable to protect a client's interests, such as giving reasonable notice to the client, allowing time for employment of other counsel, surrendering papers and property to which the client is entitled and refunding any advance payment of fee or expense that has not been earned or incurred. The lawyer may retain papers relating to the client to the extent permitted by other law.

4. ABA Model Rule 1.16 Official Comments.

(1) A lawyer should not accept representation in a matter unless it can be performed competently, promptly, without improper conflict of interest and to completion. Ordinarily, a representation in a matter is completed when the agreed-upon assistance has been concluded. See Rules 1.2(c) and 6.5. See also Rule 1.3, Comment [4].

Mandatory Withdrawal

(2) A lawyer ordinarily must decline or withdraw from representation if the client demands that the lawyer engage in conduct that is illegal or violates the Rules of Professional Conduct or other law. The lawyer is not obliged to decline or withdraw simply because the client suggests such a course of conduct; a client may make such

a suggestion in the hope that a lawyer will not be constrained by a professional obligation.

(3) When a lawyer has been appointed to represent a client, withdrawal ordinarily requires approval of the appointing authority. See also Rule 6.2. Similarly, court approval or notice to the court is often required by applicable law before a lawyer withdraws from pending litigation. Difficulty may be encountered if withdrawal is based on the client's demand that the lawyer engage in unprofessional conduct. The court may request an explanation for the withdrawal, while the lawyer may be bound to keep confidential the facts that would constitute such an explanation. The lawyer's statement that professional considerations require termination of the representation ordinarily should be accepted as sufficient. Lawyers should be mindful of their obligations to both clients and the court under Rules 1.6 and 3.3.

Discharge

(4) A client has a right to discharge a lawyer at any time, with or without cause, subject to liability for payment for the lawyer's services. Where future dispute about the withdrawal may be anticipated, it may be advisable to prepare a written statement reciting the circumstances.

(5) Whether a client can discharge appointed counsel may depend on applicable law. A client seeking to do so should be given a full explanation of the consequences. These consequences may include a decision by the appointing authority that appointment of successor counsel is unjustified, thus requiring self-representation by the client.

(6) If the client has severely diminished capacity, the client may lack the legal capacity to discharge the lawyer, and in any event the discharge may be seriously adverse to the client's interests. The lawyer should make special effort to help the client consider the consequences and may take reasonably necessary protective action as provided in Rule 1.14.

Optional Withdrawal

(7) A lawyer may withdraw from representation in some circumstances. The lawyer has the option to withdraw if it can be accomplished without material adverse effect on the client's interests. Withdrawal is also justified if the client persists in a course of action that the lawyer reasonably believes is criminal or fraudulent, for a lawyer is not required to be associated with such conduct even if the lawyer does not further it. Withdrawal is also permitted if the lawyer's services were misused in the past even if that would materially prejudice the client. The lawyer may also withdraw where the client insists on taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement.

(8) A lawyer may withdraw if the client refuses to abide by the terms of an agreement relating to the representation, such as an agreement concerning fees or court costs or an agreement limiting the objectives of the representation.

Assisting the Client upon Withdrawal

(9) Even if the lawyer has been unfairly discharged by the client, a lawyer must take all reasonable steps to mitigate the consequences to the client. The lawyer may retain papers as security for a fee only to the extent permitted by law. See Rule 1.15.

B. CASE EXAMPLES

1. *In re Disciplinary Action Against Fuller*, 621 N.W.2d 460 (Minn. 2001)

An attorney represented an individual and his businesses in bankruptcy and tax proceedings. He filed a Chapter 11 petition for one of the businesses, but later withdrew from the representation. The attorney wrote letters to the attorney for the unsecured creditors stating that the reason for the withdrawal was the client's "failure to receive chemical dependency treatment and [the client's] propensity for writing worthless checks." *Id*. at 464. The attorney wrote letters to over twenty-five people, including the Vice President of the United States, and government agencies about the client, claiming that the client had a chemical dependency problem and accusing the client of murder, fraud, and intimidation. The attorney wrote a letter to tax authorities claiming that the client had underreported the sale price of business assets. The attorney also wrote letters to some of the client's creditors that notified them of the client's prior bankruptcies and conviction for converting one of his business's 401(k) funds.

The court agreed with the referee that the attorney disclosed more information to more people than what is allowed by the rules of professional conduct. Although the attorney may have needed to notify some individuals of potential fraud, he did not need to notify the Vice President of alleged death threats. The court indefinitely suspended the attorney with reinstatement conditioned on providing evidence that he did not have a psychological problem that would interfere with his ability to competently practice law.

Michael Klein | My profile | Log out

TMA Code of Ethics

Preamble

Members of the Turnaround Management Association (hereinafter "TMA") are dedicated to the highest standards of professionalism, integrity and competence for those engaged in all matters involving turnaround and crisis management and corporate renewal. The following principles are guidelines for the conduct of members in fulfilling those obligations.

The transactions in which we engage are diverse, multifaceted and sometimes complex. It is thus not possible to state a set of rules that would prescribe proper behavior under every circumstance. However, to provide guidance and clarity, we have developed and stated our Code of Ethics.

This Code is composed of Canons and Ethical Standards. The Canons are broad principles of conduct. The Ethical Standards (E.S.) are more specific goals toward which members should aspire in professional performance and behavior.

Canon I

General Obligations and Professional Boundaries

A member shall maintain and advance knowledge of the practice of turnaround and crisis management and corporate renewal, respect the practice and contribute to its growth.

E.S. 1.1 Professional Boundaries:

A member bound by this Code of Ethics is one who is engaged in the practice of providing managerial services and consultation services to businesses, debtors, creditors and other interested parties with respect to troubled businesses, organizations and associations. While such services include a wide range of issues and problems, a member must take care not to perform services that require a license, unless the member is so licensed to perform such services.

E.S. 1.2 Standards of Excellence:
A member shall strive to improve his or her professional knowledge and skill. Within his or her practice, a member shall demonstrate a consistent pattern of reasonable care and competence.

E.S. 1.3 Conduct:
A member shall uphold the law in the conduct of his or her professional activities.

E.S. 1.4 Human Rights:
A member shall uphold human rights in all of his or her professional endeavors.

E.S. 1.5 Continuing Education:
A member shall seek out and participate in educational programs to enhance his or her professional knowledge.

Canon II
Obligations to the Client
A member shall serve his or her client independently, competently and in a professional manner. A member should exercise unprejudiced and unbiased judgment on the client's behalf.

E.S. 2.1 Professional Responsibilities:
(A) A member shall undertake to perform the engagement to the best of his or her ability; (B) A member shall not proceed with an engagement unless the client has agreed with the objectives, scope and approach to be employed and has agreed to the fee structure; (C) A member shall not undertake an engagement which cannot be fulfilled in a timely manner because of his or her commitments.

E.S. 2.2 Independence:
A member's duty is solely to the client and he or she should strive to remain independent of other affiliations that could compromise his or her judgment or result in the appearance of compromise. Prior to accepting an engagement, a member shall disclose to his or her client all financial relationships which may cloud, or give the appearance of clouding, his or her judgment. If the client is the troubled business or organization, disclosure shall be made of any past referrals from, prior work for, or an ownership interest in, any owner, creditor or customer of the client and any party offering financing to, or seeking to purchase an interest in the client. A member shall avoid conflicts of interest and the appearance of conflicts of interest.

E.S. 2.3 Competence:
A member shall not undertake an engagement for which his or her firm does not have the technical capability.

E.S. 2.4 Candor and Truthfulness:
(A) A member shall not intentionally or recklessly mislead existing or prospective clients about the results which can be achieved through the use of a member's services; (B) A member shall not offer solutions nor make recommendations that are unrealistic or impractical. The nature of proposed actions, and the potential ramifications of those actions, should be communicated to the client.

E.S. 2.5 Integrity:
(A) A member shall not disclose confidential information about his or her clients or otherwise take advantage of such information; (B) A member shall not serve a client using proprietary information developed for a previous client without obtaining the previous client's consent.

E.S. 2.6 Contingency Fees:
A member may accept a performance bonus or other contingency fee.

E.S. 2.7 Ownership:
(A) TMA recognizes the difficulties involved with respect to equity ownership of a troubled company client; (B) If a member owns or obtains a direct or indirect financial interest in a client, such interest must be disclosed to creditors and stockholders of the client on a timely basis, must be negotiated prior to the assignment and additional equity ownership should not be negotiated during the course of an engagement; (C) If an equity interest in a troubled business client results in the member gaining control of the client, the conditions and circumstances whereby the interest is obtained should be set forth in writing and agreed to prior to commencement of the engagement. Equity interests held by parties affiliated with the member shall be aggregated with the member's direct interest to determine whether or not the member would control the client. The member should insist that the client obtain legal counsel to represent the client with respect to negotiating and documenting the equity interest to be obtained by the member.

Canon III
Obligations to the Profession and to Colleagues
A member shall uphold the integrity and dignity of the profession.

E.S. 3.0: Responsibility to Colleagues:

E.S. 3.1: Each member has a responsibility to further the profession by acting with integrity and supporting the objectives and programs of the Association.

E.S. 3.2: A member shall not refer a client to a colleague in exchange for monetary consideration from that colleague or in any way share in any fee received by such colleague. For this purpose, "colleague" shall not include a member's partner, a shareholder or employee of such member's firm, or an independent contractor that has an exclusive, written contractual relationship with a member or such member's firm that predates the referral.

E.S. 3.3: A member referring a client to another member shall not make any commitments on behalf of the member receiving the referral or misrepresent the qualifications of the member receiving the referral.

E.S. 3.4: A member shall not misrepresent his or her credentials or capabilities in the pursuit of engagements.

E.S. 3.5: A member shall not disparage or make false statements about another member competing for an engagement.

E.S. 3.6: A member shall not give the impression that membership in the TMA bestows any credentials or in any way guarantees minimum qualifications.

E.S. 3.7: A member shall represent that he or she subscribes to this Code of Ethics.

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In re: UNIVERSAL BUILDING PRODUCTS, Debtor.

Chapter 11, Case No. 10-12453 (MFW) Jointly Administered

UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF DELAWARE

2010 Bankr. LEXIS 3828*; *53 Bankr. Ct. Dec. 259

November 4, 2010, Decided

COUNSEL: [*1] For Universal Building Products, Inc., dba UBP, Debtor: Dawn L. Johnson, Harley J. Goldstein, Sven T. Nylen, K&L Gates LLP, Chicago, IL; Mark Minuti, MaryJo Bellew, Michael J. Farnan, Saul Ewing LLP, Wilmington, DE; Teresa K.D. Currier, Saul Ewing, Wilmington, DE.

For Official Committee of Unsecured Creditors, Creditor Committee: Andrew I. Silfen, David John Kozlowski, James M. Sullivan, Arent Fox LLP, New York, NY; Carol C. Cohen, Arent Fox, PLLC, Washington, DC; Carol Turner English, Jeffrey N. Rothleder, Arent Fox LLP, Washington, DC; Henry F. Siedzikowski, Elliott Greenleaf & Siedzikowski, P.C., Blue Bell, PA; Rafael Xavier Zahralddin-Aravena, Shelley A. Kinsella, Elliott Greenleaf, Wilmington, DE.

JUDGES: Mary F. Walrath, United States Bankruptcy Judge.

OPINION BY: Mary F. Walrath

OPINION

MEMORANDUM OPINION[1]

1 This Opinion constitutes the findings of fact and conclusions of law of the Court pursuant to *Federal Rule of Bankruptcy Procedure 7052*, which is made applicable to contested matters by *Federal Rule of Bankruptcy Procedure 9014*.

Before the Court are the Applications of the Official Unsecured Creditors' Committee (the "Committee") to retain Arent Fox LLP ("AF") and Elliot Greenleaf & Siedzikowski, P.C. ("EG") [*2] as counsel (collectively the "Committee Retention Applications"). The Committee Retention Applications are opposed by the United States Trustee (the "UST") and the Debtors. For the reasons set forth below, the Committee Retention Applications will be denied.

I. GENERAL CASE BACKGROUND

On August 4, 2010, Universal Building Products, Inc., and several of its affiliates (collectively, the "Debtors") filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code. At the same time the Debtors filed a motion to approve a sale of substantially all of their assets to their pre-petition lenders (the "Lenders") and a motion for approval of DIP financing to allow for the sale process to continue with a projected sale hearing date in early September. At the first day hearing held on August 5, 2010, the Court set a hearing for August 23, 2010, to consider the Debtors' request for bid procedures related to the sale motion.

On August 13, 2010, the UST held an organizational meeting to determine whether there was sufficient creditor interest to form a Committee. At that time a Committee was formed and it selected AF and EG as counsel. The Committee Retention Applications were filed on August [*3] 24 and 30, 2010.

In the interim, on August 19, 2010, the Committee filed preliminary objections to the motions for approval of the sale procedures and the final DIP financing. The Committee also filed an emergency motion seeking to prohibit the Lenders from credit bidding at the proposed sale. At the August 23 hearing on the DIP financing and sale procedures motions, a global settlement among the Debtors, the Committee and the Lenders was announced pursuant to which the sale to the Lenders would proceed, with a sale hearing scheduled for September 7, 2010. (Tr. 8/23/10 at 5-6.) [2] In exchange, the Lenders would allow any excess funds from the DIP budget and the avoidance actions to be transferred to a liquidating trust for the benefit of the unsecured creditors pursuant to an agreed plan of reorganization. (Id.) After additional notice and hearing, the Court approved the proposed procedure and ultimately the sale was approved on September 7, 2010.

> 2 References to the record are as follows: "Tr. [date] at" refers to the transcript of the hearing held on the referenced date; "Liu Dep." refers to the transcript of the deposition of Dr. Haishan Liu held on September 17, 2010; "Ex. L-[#]" refers [*4] to the Liu deposition exhibits; "Ex. [letter]" and "Ex. [#]" refer to the exhibits of the Committee and the Debtors, respectively, admitted into evidence at the October 7, 2010, hearing.

On September 3, 2010, the Debtors filed an emergency motion to compel discovery related to the Committee Retention Applications. The Debtors sought discovery, inter alia, of the relationship between proposed counsel for the Committee and Dr. Haishan Liu whom the Committee had retained as a translator. [3] The Court did not grant the Debtors' motion to expedite the hearing on the emergency motion but noted at the sale hearing held on September 7, 2010, that the motion appeared to be premature because no discovery had even been served. (Tr. 9/7/10 at 8.)

> 3 No separate application was filed with respect to Dr. Liu's retention. Rather, in the application to retain AF, the Committee sought approval of Dr. Liu's retention and payment of his fees subject to *section 503(b)(3)(F)*. (See proposed form of order attached to AF retention application.)

In the interim, the global settlement apparently fell apart. When the Committee filed an objection to the Debtors' emergency motion to compel discovery on September 6, 2010, [*5] it also filed an emergency motion for the appointment of a chapter 11 trustee and to terminate the Debtors' exclusivity contending that the Debtors had filed a plan and disclosure statement on August 31, 2010, which did not comply with the parties' agreement. On September 30, 2010, the Committee filed an objection to the Debtors' disclosure statement. Most recently, on October 27, 2010, the Committee filed an emergency motion to convert these cases to chapter 7, inter alia, because the Lenders have now taken the position that the Debtors are in default of the DIP financing budget and Order and the Lenders, therefore, are under no obligation to fund a plan of liquidation.

On September 16 and 30, 2010, the UST filed an objection and supplemental objection to the Committee Retention Applications contending that counsel's disclosures under *Rule 2014* were incomplete. On September 30, 2010, the Debtors filed an omnibus objection to the Committee Retention Applications contending that proposed counsel had (1) violated the applicable Codes of Professional Conduct by having Dr. Liu solicit creditors to serve on the Committee and give him their proxy so that he could vote for counsel in exchange [*6] for being retained as a translator by the Committee and (2) violated the applicable provisions of the Bankruptcy Code and Rules by failing to disclose adequately their relationship with Dr. Liu.

A hearing was held on October 7, 2010, to consider the Committee Retention Applications and objections. After hearing evidence, the Court took the matter under advisement. [4] The parties filed post-trial briefs on October 21, 2010. The matter is now ripe for decision.

> 4 At the hearing on the Committee Retention Applications in this case, the Debtors moved into evidence pleadings filed in bankruptcy cases in Texas in which it was alleged that AF had a financial advisor, with which it had a relationship, solicit creditors for proxies to serve on the creditors' committee for the purpose of supporting AF as counsel to the committee. The Committee filed a motion to strike the Debtors' references in their pleadings to those unrelated cases and opposed the admission of those pleadings into evidence in this case on numerous grounds. The Court took that issue under advisement as well. (Tr. 10/7/10 at 105-08.) Because the Court finds that it is not necessary to consider those pleadings to sustain the Debtors' [*7] objection, the Court finds it unnecessary to consider whether those pleadings are admissible.

II. FACTUAL BACKGROUND RELEVANT TO RETENTION MOTIONS

As a result of the evidence presented, including the deposition of Dr. Liu and testimony of representatives of the respective firms proposed to be retained by the Committee, the Court finds that the following occurred between the filing of the Debtors' petition on August 4, 2010, and the Committee formation meeting on August 13, 2010.

On the day the Debtors filed their bankruptcy petitions, attorneys at both AF and EG faxed copies of the petitions and the list of the thirty largest creditors to Dr.

Liu. [5] (Liu Dep. at 51-52; Exs. L-2, L-23.) Dr. Liu testified that he received the same information from three other law firms that same day. (Id.) Dr. Liu's main business is as an authorized distributor for Fujifilm, but he also consults with Asian creditors who may have a collection problem in the United States. (Id. at 11-12.) Each of the firms who sent the information to Dr. Liu had a prior relationship with him, representing him or his Asian clients in collection or preference cases. (Id. at 115-20; Tr. 10/7/10 at 69.) Several had worked with [*8] him in cases where they served as Committee counsel while he acted as a translator or a representative of an Asian creditor. (Liu Dep. at 115-20.)

5 EG sent additional information about its analysis of the case to Dr. Liu and to several other clients and contacts known to have relationships with foreign entities. (Tr. 10/7/10 at 68-69, 96.)

Dr. Liu understood that counsel were sending him the information because they were interested in making a pitch for the Committee representation in this case. (Liu Dep. at 50-51, 58, 70, 134.) AF emailed Dr. Liu "[w]e are definitely interested in pursuing this case." (Ex. L-19; Tr. 10/7/10 at 45-46.) The attorney at EG emailed "I am sending this to you first in order to get your support early. I would like to pitch this as lead or co-counsel - no more local." (Ex. L-23.)

At the time of the bankruptcy filing, neither AF nor EG had any prior relationship with any of the Asian creditors. (Tr. 10/7/10 at 39-40, 84-85.) Nor did AF or EG have any knowledge that Dr. Liu had a relationship with any of those creditors. (Id. at 40, 85-87.) In fact, Dr. Liu did not represent any of the creditors on the creditor list at the time it was sent to him. (Liu Dep. at [*9] 46-51, 83, 155.)

In response to the information sent to him by AF and EG on August 4, 2010, Dr. Liu responded by email "As usual, at this probing stage, let's find out what those Asian creditors are going to respond and their representation status in the USA prior to the petition." (Ex. L-2.) Dr. Liu further noted that AF and EG "desire me to get a certain support from Asian Chinese exporters who might recommend [Dr. Liu] as a pending committee member in the case. . . . Before recommending you, I need some one and some groups to commend me to one or more of those prospective committee participants." (Ex. L-27.) Dr. Liu noted that "the grand cultivation of a support base from Chinese exporters" was "an invaluable asset." (Id.)

Notwithstanding having no relationship with the Asian creditors on the list, Dr. Liu made extensive efforts to contact them to educate them about the intricacies of the United States Bankruptcy Code and to see if they would give him a proxy to represent them at the Committee formation meeting. (Id. at 42-43, 46-51, 71-72, 74-78, 83-85.) Throughout this process, Dr. Liu sent almost daily emails to AF and EG reporting on his efforts to locate creditors on the list [*10] and get their proxies. (Ex. L-3, L-7, L-8, L-9, L-18; Tr. 10/7/10 at 89-90.) The AF partner involved in this process emailed Dr. Liu "Let me know if you need any assistance." (Ex. A at HL-391.) In fact, AF did assist Dr. Liu in his efforts to find contact information for the creditors. [6]

6 Dr. Liu asked AF to contact the Debtors' counsel or the UST to obtain contact information for the fourth largest creditor, but AF advised him that neither would give an attorney that information. Instead, AF recommended that Liu call them directly and gave him their phone numbers. (Tr. 10/7/10 at 41-42; Ex. L-4, L-5, L-6.) In addition, an attorney at AF forwarded to Dr. Liu an address for one of the creditors that he had obtained through an internet search. (Ex. L-11.)

While seeking to persuade the creditors to give him their proxies, Dr. Liu asked AF and EG for legal advice regarding the creditors noting that "getting a proxy is a two way traffic." (Liu Dep. at 78-81, 210-18; Ex. L-17, L-18.) The questions related specifically to how the creditors could improve their chances of getting paid for product in transit. (Liu dep. at 213, 216-18; Tr. 10/7/10 at 50-51.) AF advised Dr. Liu that the creditors [*11] could claim administrative status for that product under *section 503(b)(9)*. (Liu Dep. at 213, 216-18; Ex. L-17.)

Ultimately, Dr. Liu was "rewarded" for his efforts when two of the creditors, Eastern Accessories Corporation ("EAC") and Shanghai Hualin Hardware ("SHH"), agreed to give him their proxies. (Liu Dep. at 83, 227-28; Exs. L-8, L-22.) When Dr. Liu reported that he had secured the representation of SHH, AF responded "Excellent. That is great. Thanks." (Ex. L-10.) Dr. Liu reported to AF and EG that "I'll hold the proxy [for the larger creditor, EAC] to cheer everyone up. I strongly suggest [AF] may co-pitch with his colleagues." (Ex. L-22.)

Because he felt that the UST would not allow him to act as a proxy for both creditors, Dr. Liu decided to act as proxy only for the larger creditor, EAC, because he felt it was more likely to get on the Committee. (Id. at 74, 86, 227-28.) Dr. Liu asked AF and EG to get him a "reliable" person to hold the proxy for SHH. (Liu Dep. at 164-65; Ex. L-12.) EG responded that it could "call in a favor" and recommended a person to whom EG had recently referred business and noted that the person was not interested in making a pitch for business from the [*12] Committee (as a financial advisor) and that he "knows the rules and will serve us well." (Tr. 10/7/10 at 90, 93-94; Ex. L -14.) AF was aware of the recommendation and approved it. (Liu Dep. at 171-72; Exs. L-13 &

L-15; Tr. 10/7/10 at 44.) EG also sent Dr. Liu a form of proxy that it said complied with the UST's requirements. (Exs. L-30, L-35; Tr. 10/7/10 at 79, 92.)

EG advised Dr. Liu that the UST would ask the proxy holder questions about how it was obtained and would disqualify the holder if he had not actually communicated with the creditor before the committee formation meeting. (Exs. L-14, L-28.) This comported with Dr. Liu's experience. (Liu Dep. at 182.) As a result, a conference call was arranged among SHH, Dr. Liu, AF, EG, and the proxy holder to discuss whether the creditor wished to give its proxy. (Liu Dep. at 200-03; Tr. 10/7/10 at 45, 78, 90-91.)

The proxies that Dr. Liu obtained included the right to vote on the creditors' behalf for counsel for the Committee. (Liu Dep. at 84-85; Ex. L-14.) Dr. Liu did not discuss with the creditors which professionals he would support; the proxies gave him the discretion to decide. (Id. at 86, 313.)

At the Committee formation meeting, [*13] EAC (whose proxy Dr. Liu held) was chosen by the UST to serve on the Committee. (Tr. 10/7/10 at 79.) After it was formed, the Committee interviewed attorneys and financial advisors. Ten law firms, including AF and EG, gave presentations seeking to be retained as counsel for the Committee. (Id. at 80; Liu Dep. at 311-12.) Liu told the other Committee members that he had had dealings in other cases with AF and EG and the other law firm that was a finalist. (Tr. 10/7/10 at 11.) However, Dr. Liu did not advise the other members of the Committee of the email and other communications he had had with AF and EG leading to the formation meeting. (Id. at 16.) AF and EG were ultimately chosen as counsel by unanimous vote. (Id. at 15-16.)

Thereafter, on AF's recommendation, the Committee decided to hire Dr. Liu as a translator so that EAC could participate in Committee meetings. (Id. at 14.) Dr. Liu advised EAC that, in light of his retention as a translator, he could no longer act as its representative on the Committee and referred it to another attorney he knew. (Liu Dep. at 87-88.) However, no one advised the Co-Chair of the Committee that Dr. Liu was no longer acting as EAC's representative [*14] on the Committee. (Tr. 10/7/10 at 14-16.)

On August 30, 2010, the Committee filed the Committee Retention Applications. In its retention application, AF filed a declaration disclosing that (1) at AF's recommendation, Dr. Liu had been selected by the Committee to serve as a translator for the Committee and (2) AF had been involved in many cases where Dr. Liu served as a translator for the creditors' committee or acted as a representative of a creditor on the committee. (Ex. D at ∂ 11.) The declaration also disclosed that Dr. Liu had held a proxy for a creditor in that case. (Id.) On September 13, 2010, AF filed a Supplemental Declaration identifying two additional cases in which it was involved where Dr. Liu was the committee translator or a creditor representative, one of which had happened very recently. (Tr. 10/7/10 at 37; Ex. E.) On September 22, 2010, AF filed a Second Supplemental Declaration advising that it had "contacts" with EAC and SHH through Dr. Liu and that those creditors had "inquiries relating to the Debtors." (Tr. 10/7/10 at 38; Ex. F.) There was no revelation, however, as to the content of those communications. [7]

7 On September 29, 2010, AF filed a Third Supplemental [*15] Declaration regarding an unrelated connection with the Debtors' CRO. (Ex. G; Tr. 10/7/10 at 38.)

Attached to its retention application, EG's original Affidavit did not reveal any connection with Dr. Liu, EAC or SHH. (Ex. O; Tr. 10/7/10 at 97-98.) In a Supplemental Affidavit filed on September 15, 2010, EG revealed it had been involved in a number of cases in which Dr. Liu was involved as a translator or creditor representative. (Ex. P.) In a Second Supplemental Affidavit, filed on September 23, 2010, EG revealed that it had had contacts with Dr. Liu and EAC and SHH prior to the formation meeting, including providing a proxy and introducing a proxy holder for SHH. (Ex. 52.)

At the hearing, the Committee offered a declaration which contained a chart of all seventeen bankruptcy cases in which Liu had been involved. (Exs. J & K.) AF had been counsel to the Committee in six of those cases, Lowenstein Sandler had been counsel in five, and six different firms had been counsel in the other six cases. (Tr. 10/7/10 at 16-19; Ex. K.) A second chart detailed the seventy bankruptcy cases in which AF had been counsel to the committee since 2003. (Ex. M.) Dr. Liu was involved in only six of them. (Id.) [*16] If one considers only the cases since June 4, 2008, when Dr. Liu apparently first became involved in bankruptcy matters with AF, however, there are twenty-seven cases in which AF served as committee counsel including three in which Liu served as translator for the committee and three in which Liu acted as a representative of committee members. (Exs. K, M.)

III. JURISDICTION

The Court has jurisdiction over this matter which is a core proceeding pursuant to *28 U.S.C. ßß 1334* & *157(b)(2)(A)* & *(O)*.

IV. DISCUSSION

A. Standing

As a preliminary matter, EG asserts that the Debtors have no standing to object to the Committee Retention Applications because they have no interest in whom the Committee chooses to represent them. Specifically, EG argues that to have standing to be heard on the issue presented in this case the Debtors must show that resolution of the issue will diminish the Debtors' property, increase their burdens, or impair their rights. See, e.g., *In re ANC Rental Corp., 57 Fed. Appx. 912, 2003 U.S. App. LEXIS 2159, at *7 (3d Cir. Dec. 13, 2002)*; *Newspaper & Mail Deliverers' Union, 1991 U.S. Dist. LEXIS 16337 (S.D.N.Y. Nov. 12, 1991)*.

The Court rejects this argument. *Section 1109* expressly grants the [*17] Debtors the right to appear and be heard on any issue in their cases. *11 U.S.C. ß 1109*. In addition, any attorney with knowledge of a violation of applicable rules of professional conduct by another may be obligated to report that violation. [8] Therefore, the Court finds that the Debtors do have standing to object to the Committee Retention Applications.

> 8 Rule 8.3 Reporting Professional Misconduct provides that:
>
> > (a) A lawyer who knows that another lawyer has committed a violation of the Rules of Professional Conduct that raises a substantial question as to that lawyer's honesty, trustworthiness or fitness as a lawyer in other respects, shall inform the appropriate professional authority.

B. Violation of Rules of Professional Conduct

The Debtors contend that the Committee Retention Applications should be denied because proposed Committee counsel violated the applicable rules governing attorney conduct. Specifically, the Debtors cite Rule 7.3 of Delaware's Rules of Professional Responsibility which provides:

> A lawyer shall not by in-person, live telephone or real-time electronic contact solicit professional employment from a prospective client when a significant motive for the lawyer's doing [*18] so is the lawyer's pecuniary gain, unless the person contacted: (1) is a lawyer; or (2) has a family, close personal, or prior professional relationship with the lawyer.

Del. Lawyers' R. of Prof. Cond. 7.3. This rule is identical to Rule 7.3 of the Model Rules of Professional Conduct. Rule 7.3 of the New York Rules of Professional Conduct is similar: "[a] lawyer shall not engage in solicitation by in-person or telephone contact, or by real-time or interactive computer-accessed communication unless the recipient is a close friend, relative, former client or existing client. . . ."

The comments to Rule 7.3 make it clear that a lawyer is also prohibited from using another as an intermediary to solicit prospective clients. The Annotations to Model Rule 7.3 provide:

> Lawyers may not use other people to solicit for them, and Rule 7.3 is sometimes invoked along with either Rule 7.2(b) (prohibiting paid recommendations) or Rule 8.4 (prohibiting use of third parties to violate Rules) to prohibit the practice. See, e.g., *In re O'Keefe, 877 So. 2d 79 (La. 2004)* (lawyer disbarred for paying "runners" to find and refer personal injury cases); *Miss. Bar v. Turnage, 919 So. 2d 36 (Miss. 2005)* (lawyer [*19] suspended for hiring former insurance salesperson to solicit clients for potential class suit against insurer); Md. Ethics Op. 98-30 (1988) (lawyer may not have bail bondsman pass out bondsman's business cards with lawyer's contact information printed on back); see also *Cincinnati Bar Ass'n v. Rinderknecht, 79 Ohio St. 3d 30, 1997 Ohio 309, 679 N.E.2d 669 (Ohio 1997)* (lawyer indefinitely suspended for setting up direct marketing service to solicit accident victims as clients for himself and chiropractor; decided under Ohio Code); cf. *Crook v. State, No. 08-020003820CR, 2005 WL 1539187 (Tex. App. June 30, 2005)* (lawyer convicted of felony barratry for hiring chiropractor's assistant to solicit auto accident victims; court invokes Rules 7.3 and 8.4 in analyzing offense).

Annotations to ABA-AMRPC Rule 7.3. See also Thomas E. Ray, Solicitation of Clients: Are There Any Guidelines?, 21 NOV Am. Bankr. Inst. J. 12 (2002) (suggesting that direct solicitation by phone or in person of creditors on the debtor's schedules by counsel hoping to be retained as counsel to the committee was unethical).

AF and EG argue that the Rule cannot be constitutionally applied to them to prohibit their activities in this case. They argue that, [*20] because committee members are often sophisticated business entities, restricting attorney solicitations to them runs afoul of the *First Amendment*. See, e.g., *Edenfeld v. Fane, 507 U.S. 761, 774-75, 113 S. Ct. 1792, 123 L. Ed. 2d 543 (1993)* (striking Florida statute which prohibited CPAs from directly soliciting accounting clients and noting that business clients are different from the "unsophisticated, injured or distressed lay person" often targeted by attorney's solicitations). See also Samuel L. Bufford, Attorney Solicitation of Legal Work in Business Settings, County Bar Update, Vol. 26, No. 4 (April 2006) (arguing that California's disciplinary rule prohibiting direct solicitation of prospective unrelated clients by attorneys in the business context is unconstitutional).

The Court disagrees. The issue in this case is not the propriety of written "advertising" issued by AF and EG. In fact, the Court finds nothing wrong with AF and EG sending the list of creditors to their clients and contacts with whom they have a professional relationship. Nor does the Court object to EG's sending its "analysis" of the Debtors' case to those same entities. See generally Michael P. Richman, Chasing Committees: the Ethics of Entertainment [*21] Solicitation, 22 OCT Am. Bankr. Inst. J. 18 (2003) (noting that written solicitation of prospective clients - giving counsel's qualifications - is permissible but that entertainment solicitation - wining and dining prospective committee members before the formation meeting - was unethical).

What the Court finds improper in this case is that once AF and EG learned that Dr. Liu did not represent any creditor on the list, they actively encouraged and assisted him in his efforts to solicit creditors to get their proxies to attend the formation meeting and vote for counsel. The Supreme Court has expressly held that state bar associations may prohibit direct oral communications with prospective clients by an attorney or by someone on his behalf. *Ohralik v. Ohio Stat Bar Ass'n, 436 U.S. 447, 464-66, 98 S. Ct. 1912, 56 L. Ed. 2d 444 (1978)* (upholding states' right to prohibit direct solicitation by attorneys given states' compelling interest in preventing abuses and significant potential for harm to prospective clients by attorneys "trained in the art of persuasion"). That precedent has not been changed in the business context. Further, the Court finds it particularly unwise to change it in the context of this case. In this [*22] case the prospective clients who were solicited were foreign creditors unfamiliar with our bankruptcy laws and particularly with the system of forming creditors' committees. They are no less vulnerable to direct solicitation by someone on behalf of an attorney than an individual. [9]

9 In fact, Dr. Liu himself (a sophisticated businessman who is familiar with our bankruptcy laws and procedures) said he felt uncomfortable when attorneys sent him emails and approached him at formation meetings asking for his support. (Liu Dep. at 205-09, 271.) Dr. Liu also complained that many proxy holders only showed up at the formation meeting (ostensibly to vote for professionals) and then never participated in the case again. (Id. at 208.) Ironically, that is exactly what Dr. Liu himself did; he directly solicited EAC and SHH for their support with the intention of only representing them at the formation meeting and not thereafter.

Further, the practice at issue here has been a matter of criticism under the Act and the Bankruptcy Code was enacted to change some of those practices (or at least to shed some light on them by requiring disclosures). See, e.g., H.R. No. 595, 95th Cong., 2d Sess. 93, reprinted [*23] in 1978 U.S. Code Cong. & Ad. News 6054 (criticizing the practice of "creditors' attorneys with proxies participat[ing] actively in the election of the members of the committee in order that they may be selected as counsel to the committee" which "is a lucrative position."). Cf. *In re ABC Auto. Prods. Corp., 210 B.R. 437, 443 (Bankr. E.D. Pa. 1997)* (criticizing committee counsel for using members' proxies to conduct committee business without any input from committee members).

AF and EG argue further, however, that their activity did not violate any ethical rule. At the hearing on the instant motion, the partner at AF leading the engagement testified that he never asked Dr. Liu to solicit clients for AF or creditors to serve on a creditors' committee "on behalf of AF." (Tr. 10/7/10 at 23.) He explained the language in his emails thanking Dr. Liu for his efforts and asking if he needed any assistance as simple common courtesy. (Id. at 27-28.) He further denied having any discussion with EG regarding what they expected Dr. Liu to do for them, other than to allow them to demonstrate that they were the best firm for the Committee to hire. (Id. at 28-29.) The partner in charge of the EG [*24] engagement also denied that he asked Dr. Liu to solicit any clients on its behalf and also stated that he was just hoping for a recommendation and "a fair shot to go in and present our case as to why we should be Committee counsel." (Id. at 72, 81-82.) EG also denied offering Dr. Liu or the proxy chosen for SHH anything of value for voting for them. (Id. at 82.) Both firms vehemently denied asking Dr. Liu to solicit creditors for them.

The Court finds that the evidence proves otherwise and finds that, in fact, AF, EG and Dr. Liu were acting in concert to cold-call creditors that Dr. Liu did not represent for the purpose of being retained by them to attend the Committee formation meeting and to cast a proxy in favor of AF and EG for counsel. This is demonstrated by the following facts: (1) as a result of the communications between Dr. Liu, AF and EG, it was clear to counsel that Dr. Liu did not represent any of the creditors at the time he first endeavored to contact them; (2) Dr. Liu kept AF and EG apprised (on at least a daily basis) of his efforts to locate and obtain proxies from the creditors and noted that he would act "as usual" in doing so; (3) Dr. Liu asked for assistance in [*25] locating the creditors and AF provided advice and some assistance; (4) Dr. Liu expressly stated that he understood that counsel wanted him to get "support" from the creditors and that they were interested in serving as Committee counsel; (5) to persuade the creditors to provide proxies, Dr. Liu asked for (and AF provided) legal advice relevant to those creditors' rights as part of the "two way traffic;" (6) Dr. Liu asked for a nominee to serve as a proxy for one of the creditors and EG made a recommendation (approved by AF) of someone who "will serve us well;" (7) when Dr. Liu got EAC's proxy he said he would serve as the proxy which would "cheer everyone up" and that AF and EG should definitely make a pitch for the Committee now; (8) both AF and EG were on the conference call with one of the creditors, SHH, to discuss the case and persuade it to execute a proxy; (9) Dr. Liu did vote the EAC proxy in favor of AF and EG at the committee formation meeting; and (10) AF immediately recommended that the Committee retain Dr. Liu as a translator.

AF and EG note, however, that they were not the only attorneys seeking Dr. Liu's assistance or asking him to vote any proxies he held for them as [*26] counsel. Rather than excusing the behavior of AF or EG, however, it simply evidences that others may not be complying with the rules either. [10] The Court is only able to address the issue before it: the conduct of AF and EG. The Court would caution other counsel who observe violations of the Rules of Professional Responsibility or Model Rules of Professional Conduct in other cases to bring it to the Court's attention for proper action. See Rule 8.3 of the Model Rules of Professional Conduct. See generally Thomas E. Ray, Solicitation of Clients: Are There Any Guidelines?, 21 NOV Am. Bankr. Inst. J. 12 (2002) (noting that attorneys who are aware of ethical violations are obligated by Model Rule 8.3(a) to report such violations).

10 In fact, Dr. Liu testified that counsel for the Debtors had approached him at an organizational meeting of creditors in another case ostensibly to get his support when he made a pitch. (Liu Dep. at 314.)

Therefore, the Court concludes that there are sufficient facts to suggest that AF and EG did violate Rule 7.3 and Rule 8.4 of the Model Rules of Professional Conduct and of Delaware's Rules of Professional Responsibility. The Court finds this conduct sufficient [*27] reason to disqualify AF and EG from serving as counsel to the Committee in this case. See, e.g., *In re Vanderbilt Assoc., Ltd.., 117 B.R. 678, 680 (D. Utah 1990)* (noting that ethical rules apply to question of whether an attorney can be employed pursuant to *ß 327 of the Bankruptcy Code*); *Berger McGill, Inc. v. Capozzoli (In re Berger McGill, Inc.), 242 B.R. 413, 423 (Bankr. S.D. Ohio 1999)* (disqualifying law firm from representing debtor in action against creditor/former client where creditor had previously consulted and provided confidential information to counsel about the subject of the law suit); *In re Soulisak, 227 B.R. 77, 80 (Bankr. E.D. Va. 1998)* ("Attorneys who practice before a bankruptcy court must not only concern themselves with the obligations set forth in the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure, but also with the application of state ethical rules."); *In re RKC Dev. Corp., 205 B.R. 869, 873 (Bankr. S.D. Ohio 1997)* (concluding that appointment under *ß 327* should be refused where retention is at variance with ethical and disciplinary rules); *In re Sauer, 191 B.R. 402, 407 (Bankr. D. Neb. 1995)* (disqualifying counsel for failure to observe applicable [*28] state ethics code).

C. Failure to be Disinterested

The Debtors also contend that AF's Retention Application should be denied because AF is not disinterested. While *section 1103(b) of the Bankruptcy Code* provides only that Committee counsel may not represent an entity with an interest adverse to the Committee, [11] the Debtors contend that *section 328* imposes the additional requirement that Committee counsel be disinterested. [12] In this case, the Debtors contend that AF is not disinterested because it provided legal advice to several creditors that they could assert administrative claims for goods in transit, which is contrary to the interests of the general unsecured creditors represented by the Committee.

11 "An attorney . . . employed to represent a committee . . . may not, while employed by such committee, represent any other entity having an adverse interest in connection with the case." *11 U.S.C. ß 1103(b)*.

12 *Section 328(c)* provides that the Court may disallow counsel fees "if, at any time during such professional person's employment . . . such person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on [*29] which such professional person is employed." *11 U.S.C. ß 328(c)*.

At the hearing the AF partner admitted that he responded to Dr. Liu's email regarding the question of what creditors' rights were with respect to in-transit goods. (Tr. 10/7/10 at 29.) He denied, however, that he was providing legal advice to the creditors, stating that Dr. Liu often asked counsel who were interested in pitching for Committee representation "hypothetical" questions to see who was the most knowledgeable. (Id. at 29.) Further, he noted that he gave the "advice" to Dr. Liu not to the creditors and that there was no attorney/client relationship ever established between AF and the creditors. (Id. at 31.) He stated that it was no different from the hundreds of questions he gets from acquaintances at cocktail parties and in the hall. (Id. at 31, 53.)

The Court disagrees. The emails were far from hypothetical cocktail party conversation; they expressly referenced the names of the creditors and amounts of their claims in the "re" lines and in the text. (Tr. 10/7/10 at 53-58; Ex. L-17, L-18.) Further, the legal advice was given in the context of AF's effort to win Dr. Liu's support for its pitch to become Committee [*30] counsel. Even if AF did provide legal advice to the creditors (through Dr. Liu), however, the Court concludes that AF is not disqualified from serving as Committee counsel on the basis that it is not disinterested.

The Court disagrees with the Debtors' argument that committee counsel generally cannot be retained if they are not disinterested. *Section 1103* specifically provides only that committee counsel shall not hold or represent an interest adverse to the committee. That section expressly states that the representation of a creditor in the case (which would make the attorney not disinterested [13]) is not a per se disqualifying factor as suggested by the Debtors. [14] See, e.g., *In re Firstmark Corp., 132 F.3d 1179, 1182-83 (7th Cir. 1997)* (finding no disqualification where counsel for committee represented former president of the debtor - who was a possible creditor and avoidance action defendant - in matters unrelated to the debtor); *In re Nat'l Century Fin. Enters., Inc., 298 B.R. 112, 118 (Bankr. S.D. Ohio 2003)* (finding firm not disqualified from representing committee although it concurrently represented two members of the committee).

> 13 Disinterested is defined in the Code to include [*31] "a creditor" or anyone with "an interest materially adverse to the interest of the estate." *11 U.S.C. ß 101(14)*.
>
> 14 Cf. *11 U.S.C. ß 327(c)* (counsel is not per se disqualified from representing the trustee simply because of its prior representation of a creditor).

The fact that committee counsel also represents an individual creditor has been found to be at most a potential conflict.

> Congress implicitly determined that the inherent tension between a committee and one of its creditors, standing alone, was immaterial and any conflict too theoretical to warrant being classified as an adverse interest. That is, merely the remote potential for dispute, strife, discord, or difference between a committee and one of its creditors does not give rise to any conflict of interest or appearance of impropriety that would bar an attorney from representing both parties.

In re Nat'l Liquidators, 182 B.R. 186, 192-93 (S.D. Ohio 1995) (concluding that only when "evidence suggest[s] the existence of possible challenges to a creditor's claim, the existence of a possible recovery action against the creditor, or the existence of any possible dispute between a committee and one of its constituents or members" would [*32] counsel be disqualified under *ß 1103*).

A potential conflict alone does not mandate disqualification of counsel for the Committee. See, e.g., *In re First Jersey Sec., Inc., 180 F.3d 504, 509 (3d Cir. 1999)* (stating that the Bankruptcy Code "mandates disqualification when there is an actual conflict, allows for it when there is a potential conflict, and precludes it based solely on an appearance of a conflict.").

Furthermore, the time to evaluate whether AF is disqualified, because it represents an interest adverse to the Committee, is at the time of retention. Prior representations, even if adverse to the interests of the committee or unsecured creditors, do not disqualify committee counsel. *See, e.g., In re Enron Corp., No. 02 Civ. 5638 (BSJ), 2003 U.S. Dist. LEXIS 1442, 2003 WL 223455, *6-7 (S.D.N.Y. Feb. 3, 2003)* (finding committee counsel did not hold an adverse interest because it had previously represented debtor-related entities and stating that the "argument under *ß 1103* fails because [counsel's] alleged adverse interests . . . predated [counsel's] representation of the committee"); *In re Diva Jewelry Design, Inc., 367 B.R. 463, 473-74 (Bankr. S.D.N.Y. 2007)* (finding that discussions that proposed trustee's [*33] counsel had with creditors regarding their possible consignment claims prior to retention by trustee did not disqualify counsel from employment); *Nat'l Century Fin., 298 B.R. at 118* (finding firm not disqualified from representing committee although it had previously represented the debtor in a discreet matter that ended before bankruptcy).

Therefore, even if AF "represented" EAC and SHH as a result of the legal advice given to Dr. Liu on their behalf, that is insufficient to disqualify it per se. Further, the Court finds that there is no evidence that AF actually entered into an attorney/client relationship with either EAC or SHH or that that legal representation continued to the time of AF's retention by the Committee.

D. Failure to Disclose

The Debtors (and the UST) argue, however, that the Committee Retention Applications should be denied because proposed counsel failed to disclose adequately their connections with Dr. Liu and with EAC and SHH in their original retention applications. *Rule 2014(a)* requires that

> The application [of any professional person seeking retention by the debtor or committee] shall be accompanied by a verified statement of the person to be employed setting forth [*34] the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.

Fed. R. Bankr. P. 2014(a). Delaware Local Rule 2014-1(a) also requires that additional disclosures be made "[p]romptly after learning any additional material information relating to such employment (such as potential or actual conflicts)."

"Defective disclosure is not a minor matter. It goes to the heart of the integrity of the bankruptcy system. . . ." *In re B.E.S. Concrete Prods., Inc., 93 B.R. 228, 236-38 (Bankr. E.D. Cal. 1988)* (disqualifying special counsel who failed to disclose that it represented co-defendants in litigation it was handling for debtor). The professional must disclose all contacts, not pick and choose which to disclose and which to ignore or leave the court to search the record for such relationships. *In re BH&P, Inc., 949 F.2d 1300, 1317-18 (3d Cir. 1991)* (finding failure to disclose potential conflict which counsel had discussed with UST was inadvertent but violative of *Rule 2014* nonetheless); *In re Jore Corp., 298 B.R. 703, 732 (Bankr. D. Mont. 2003)* [*35] (disqualifying counsel for debtor for failure to disclose that conflicts waiver obtained from DIP lender prohibited debtor's counsel from undertaking litigation adverse to it); *In re Granite Partners, L.P., 219 B.R. 22, 35 (Bankr. S.D.N.Y. 1998)* (noting that "professional's duty to disclose is self-policing . . . . [and court] should not have to 'rummage through files or conduct independent factfinding investigations' to determine if the professional is disqualified") (quoting *In re Rusty Jones, Inc., 134 B.R. 321, 345 (Bankr. N.D. Ill. 1991))*.

Failure to disclose connections itself is enough to warrant disqualification of counsel from employment. See, e.g., *In re Crivello, 134 F.3d 831, 839 (7th Cir. 1998)* (stating that "a bankruptcy court should punish a willful failure to disclose connections under *Fed. R. Bankr. P. 2014* as severely as an attempt to put forth a fraud on the court."); *Rome v. Braunstein, 19 F.3d 54, 59 (1st Cir. 1994)* (warning that "[a]bsent the spontaneous, timely and complete disclosure required by *section 327(a)* and *Fed. R. Bankr. P. 2014(a)*, court-appointed counsel proceed at their own risk.") (emphasis in original); *In re Filene's Basement, Inc., 239 B.R. 845 (Bankr. D. Mass. 1999)* [*36] (disqualifying counsel because of false 2014 disclosures alone without deciding whether counsel was disinterested); *In re Tinley Plaza Assoc., L.P.., 142 B.R. 272, 280 (Bankr. N.D. Ill. 1992)* (firm disqualified from representing debtor where original retention application failed to disclose that "of counsel" to firm was president of investment banking firm providing services for debtor). But see *In re Leslie Fay Cos., Inc., 175 B.R. 525, 539 (Bankr. S.D.N.Y. 1994)* (finding that failure of counsel to disclose potential conflicts did not warrant disqualification but did warrant sanction requiring counsel to pay the substantial fees incurred in having an examiner investigate its potential conflicts).

In this case the Court finds that the evidence supports disqualification of both AF and EG from representing the Committee. Although AF at least disclosed that it had a prior relationship with Dr. Liu, having served as committee counsel in cases where he represented a creditor or acted as a translator to the committee, the Court finds that disclosure deficient. AF argues that complete disclosures were ultimately made, before the hearing on consideration of the Committee Retention Applications. [*37] The Court agrees with the UST, however, that the subsequent disclosures by AF and EG (filed only after concerns about them were expressed by the Debtors and the UST and after discovery revealed what had occurred) were not enough to cure the original deficiencies. [15] AF (and EG) should have fully disclosed at the outset their efforts in support of Dr. Liu's attempt to obtain proxies from creditors to attend the Committee formation meeting. Further, while it was not a disqualifying factor, the fact that AF had provided legal advice to two creditors on their right to seek administrative claims is a fact that should have been revealed to the Committee and to the Court. Because AF and EG did not make sufficient disclosures in their original retention applications, the Debtors and the UST were obligated to engage in discovery to garner the facts and bring them to the Court's attention. The failure to provide complete and accurate disclosure at the outset warrants denial of the Committee Retention Applications. [16]

15 Although AF did disclose it had communications regarding two of the creditors, it did not provide details about those communications or provide any details about other communications [*38] it had with Dr. Liu in an effort to obtain creditor proxies.

16 The Court finds that this disclosure requirement applies to all professionals under *Rule 2014*. Although a financial advisor and others are not bound by the same Rules of Professional Responsibility that attorneys are, the Court concludes that, because solicitation efforts go to the integrity of the process, all professionals should disclose any direct calls they made (or others made on their behalf) to creditors (who were not their respective clients) in an effort to be employed in a bankruptcy case.

F. Further Recommendations

The Court hopes that by requiring disclosure of the practice of using others to solicit proxies to act at a committee formation meeting will go a long way to discourage that improper practice. The Court would also urge the UST to consider implementing procedures to reduce the likelihood of undue influence on the decision of a committee to hire professionals. Specifically, the Court recommends that the UST adopt the suggestion by Dr. Liu that the creditors be kept in a separate room from prospective professionals (who do not represent a client eligible to serve on the Committee) before the committee formation [*39] meeting. Further, the UST might consider amending the questionnaire it sends to prospective committee members to include questions regarding whether they were solicited by anyone in connection with the case.

V. CONCLUSION

For the reasons set forth above, the Court will deny the Committee Retention Applications.

An appropriate order is attached.

Dated: November 4, 2010

BY THE COURT:

/s/ Mary F. Walrath

Mary F. Walrath

United States Bankruptcy Judge

ORDER

AND NOW, this **4th** day of **NOVEMBER, 2010**, upon consideration of the Applications of the Official Unsecured Creditors' Committee (the "Committee") to retain counsel, the opposition thereto and for the reasons set forth in the accompanying Opinion, it is hereby

ORDERED that the Applications are **DENIED**.

BY THE COURT:

/s/ Mary F. Walrath

Mary F. Walrath

United States Bankruptcy Judge

In The Matters Of: CF HOLDING CORP., Debtor; COLT'S MANUFACTURING CO., INC., Debtor

Case No. 2-92-01038, Case No. 2-92-01039 Chapter 11 (JOINTLY ADMINISTERED)

UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF CONNECTICUT

164 B.R. 799*; *1994 Bankr. LEXIS 226*; *30 Collier Bankr. Cas. 2d (MB) 1604

February 17, 1994, Decided

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JUDGES: KRECHEVSKY

OPINION BY: ROBERT L. KRECHEVSKY

OPINION

[*800] *AMENDED RULING ON OBJECTIONS TO FEE APPLICATIONS*

I.

ISSUES

This ruling deals with two of the final fee applications filed in these chapter 11 cases. The first issue is whether Zolfo, Cooper & Co. (Zolfo, Cooper), special financial advisor and bankruptcy consultant to C.F. Holding Corp. (Holding) and Colt's Manufacturing Co., Inc. (Colt's) (together, the debtors), breached its fiduciary obligation when Steven F. Cooper (Cooper), the managing partner of Zolfo, Cooper, agreed during his employment with the debtors to invest $ 2 million in an entity whose controlling principal was seeking to purchase a majority interest in the reorganized debtors and Zolfo, Cooper then failed to disclose timely such action. A second issue is whether a fiduciary obligation existed requiring Weil, Gotshal & Manges (Weil, Gotshal), as attorneys for the debtors, to take steps to bring the matter before the court after Weil, Gotshal acquired actual knowledge of Cooper's actions. The Creditors' Committee (Committee), supported in part by the Office of the United States Trustee, has raised the issue through objections to the Zolfo, Cooper and Weil, Gotshal fee [**3] applications which total over $ 4.5 million. The [*801] following background is based upon oral argument and extensive briefing with accompanying exhibits submitted by the parties.

II.

BACKGROUND

The debtors were formed in 1990 during an intricate, highly leveraged buy-out transaction to acquire the manufacturing operations for the production of the world-famous Colt weapons. Holding is the sole owner of Colt's, the entity which purchased the manufacturing operations in the leveraged buyout. A limited partnership, CF Intellectual Property Limited Partnership (Name Partnership), was simultaneously formed to acquire the trademark, patent, copyright and similar rights to be licensed to Colt's. The limited partners in the Name Partnership also purchased or received stock in Holding. The State of Connecticut Retirement Funds were a major investor, holding a 49.5% partnership interest in the Name Partnership, all of Holding's Class A and B preferred stock, and about 65% of Holding's Class A common stock.

Within two years after their formation, the debtors, on March 18, 1992, filed simultaneous chapter 11 petitions. The court, on application of the debtors, authorized on April 2, 1992 the employment [**4] of Zolfo, Cooper as special financial advisors and bankruptcy consultants under a general retainer. An affidavit submitted by Cooper stated that none of the partners or employees of Zolfo, Cooper held any adverse interest to the debtors, their creditors, or any party-in-interest; that Cooper would be the partner responsible for this engagement; and that, in general, Zolfo, Cooper would assist the debtors "in restructuring the business and developing, negotiating and confirming Plans of Reorganization." [1] Cooper Affidavit of March 18, 1992 at 3.

1 Cooper's affidavit further described the firm's qualifications as follows:

> As the premier independent accounting and consulting firm specializing exclusively in advising debtors, creditors, investors and court-appointed officials in formal bankruptcy proceedings and out-of-court workouts, ZC & Co. has significant qualifications and experience in these matters. ZC & Co. has few true competitors matching its quality reputation, breadth of experience, and proven track record for success, earned in serving clients in numerous nationally prominent bankruptcy proceedings.

Id. at 5.

[**5] The court authorized the retention of Weil, Gotshal as lead attorneys for the debtors on the same date. The Weil, Gotshal partner in charge of the debtors' cases was Deryck A. Palmer, Esq. (Palmer). Shortly after the filing, the debtors negotiated a $ 35.5 million postpetition credit agreement with Creditanstalt Bankverein (the Bank), its prepetition lender. The Connecticut Development Agency (CDA) is a lender participant with the Bank.

Cooper originally devoted his efforts to "negotiate a stand-alone plan." Cooper Deposition at 47. Toward the end of 1992, Cooper concluded that the best hope for a successful reorganization lay in the debtors' securing "third-party investors" to make a substantial equity investment. *Id.* at 84. By September 1992, Cooper had spoken to William R. Berkley (Berkley), who had expressed an interest in the possible acquisition of the debtors. Cooper had previously been hired by Berkley during 1989 or 1990 in another bankruptcy case, and they knew each other socially. Cooper, along with Palmer, were also contacting other entities in late 1992 whom they believed might be interested in acquiring the debtors.

Cooper, on January 25, 1993, signed a subscription [**6] agreement contracting to invest $ 2 million in Interlaken Investment Partners, L.P. (Interlaken Investment), a new entity created and controlled by Berkley. On that date Cooper sent a $ 140,000 check directly to Berkley as the initial payment due on the subscription.

During March 1993, Berkley's interest in the debtors apparently heightened, and Cooper sent to Berkley financial information about the debtors that was no different than information sent to other potential investors. In order to receive such information, Berkley, on March 23, 1992, sent Cooper an executed confidentiality agreement required by the debtors of all interested acquirors. Berkley signed the agreement on behalf of [*802] one of his companies, Interlaken Capital, Inc. (Interlaken Capital). During April 1993, Palmer met several times with Berkley's attorneys, negotiating the terms for the acquisition of a majority interest in the reorganized debtors.

On May 17, 1993, Berkley's agents sent to the debtors a detailed draft letter outlining the terms and conditions for the acquisition by Interlaken Investment, not Interlaken Capital, of a majority interest in the reorganized debtors. At the hearing on the present fee applications, [**7] an affidavit from Berkley was received in evidence in which he stated that in "the spring of 1993" he decided to pursue his interest in the debtors "through Interlaken Investment Partners, L.P." Berkley Affidavit at 2. Berkley also averred that "I first talked to Steve Cooper about Colt's when I heard about the company's entry into bankruptcy," and "Steve Cooper never disclosed to me the terms of any competitive bid for Colt's." *Id.* at 2-3.

Cooper sent a letter dated May 21, 1993 to Ronald C. Whitaker (Whitaker), Chairman of the Board of Directors of the debtors, which read as follows:

> This letter is to advise you that I have a personal investment in an entity by the name of Interlaken Investment Partners, L.P. ("Interlaken"). As you know, Interlaken is in the process of making an offer to acquire a substantial equity position in Colt's Manufacturing Company (the "Company"). Given the nature of our retention as financial advisors to the Company, the appearance of a potential conflict and the Bankruptcy Code's requirement of disinterestedness, I am formally requesting that the Board of Directors designate a replacement repesentative [sic] to negotiate with Interlaken the financial [**8] terms of an investment in the Company. With respect to all other financial matters, we will continue to represent the Company.
>
> I trust the foregoing is acceptable to the members of the board of directors. Should that not be the case, please advise me immediately.

The debtors' Board of Directors (Board) held a meeting on May 24, 1993 at which the proposal from Interlaken Investment was reviewed. Also present were Cooper's principal assistant at Zolfo, Cooper, Randy Waits, and Palmer. The Board discussed as well the merits of a plan of reorganization being jointly proposed by the Committee and the Bank not involving new investor contributions. Whitaker presented Cooper's letter and the "Board then agreed that Mr. Bloom [a Colt's director] would act in Zolfo, Cooper & Company's place in all Interlaken negotiations." Minutes of May 24, 1993 Board Meeting at 2. The meeting was continued to the next day, May 25, 1993, when the "Board agreed that Ron Whitaker should try to meet with [Governor Lowell P. Weicker, Jr.] as soon as possible." *Id.* at 3. The meeting was recessed to May 28, 1993, at which time Whitaker reported that he had met with Governor Weicker who stated that the State [**9] of Connecticut did not support a plan involving a new investor. Whitaker also advised the Board that the Bank, as a condition of continued financing, required that Weil, Gotshal and Zolfo, Cooper no longer accrue professional fees. *Id.* at 3-4.

Notwithstanding the State of Connecticut's apparent dislike for a plan involving a third-party investor, the CDA resumed discussions with Berkley. On or about September 27, 1993 the CDA circulated among the parties a draft plan of reorganization identifying a new investor as "[Interlaken Capital, Inc.]."

On November 1, 1993, Berkley's attorneys sent to the separate attorneys for the Committee, the debtors, the Bank and the CDA a document entitled "New Investor Agreement", outlining the terms for the acquisition of 85% of the common stock of the reorganized debtors by Interlaken Investment for a $ 12 million purchase price. A footnote in the document stated: "Stephen Cooper is a limited partner of the New Investor and is a principal in Zolfo, Cooper & Co., Inc., the Debtors' financial advisors. As a limited partner, Stephen Cooper is a passive investor with no input into investing decisions of the New Investor". New Investor Agreement at [**10] 7 n.1. This was the first notice to the Committee of Cooper's interest in the debtor's potential purchaser.

[*803] The CDA and the debtors shortly thereafter became the joint proponents of a plan of reorganization based upon the Interlaken Investment offer. The Third Amended Disclosure Statement approved in connection with this plan included the following statement in the section identifying the "New Equity Investor":

> Interlaken Investment Partners, L.P. (the "New Investor") is a Delaware limited partnership with its principal place of business at 165 Mason Street, Greenwich, Connecticut. The New Investor has advised the Proponents that it was formed in November 1992 for the purpose of making equity and other venture capital investments that will generally result in control of private corporations in the United States and abroad, that the general partner of the New Investor is Interlaken Management Partners, L.P. ("Management partners"), a Delaware limited partnership, that the general partner of Management Partners is Lake Management,

> Inc., a Delaware corporation, the capital stock of which is owned by William R. Berkley, and that the limited partners of the New Investor are individuals [**11] and financial institutions. Stephen Cooper is a limited partner of the New Investor and is a principal of Zolfo, Cooper & Co., Inc., the Debtors' financial advisors. The New Investor has indicated that as a limited partner, Mr. Cooper is a passive investor with no input into investment decisions of the New Investor.
>
> Mr. Cooper has advised the Proponents that when the Debtors determined that a viable plan of reorganization required outside funding, he spoke with several potential investors about the Colt situation, that William Berkley, who manages several investment funds, was one of those individuals, and that in the spring of 1993, Mr. Berkley identified Interlaken as the investment vehicle with which he would pursue his interest in Colt. In May 1993, Mr. Cooper disclosed his passive interest in Interlaken to Colt's Board of Directors and removed his firm from discussions between the parties. Mr. Cooper indicates that neither he nor his firm had any involvement in negotiating the New Investor Agreement.
>
> Mr. Cooper has advised the Proponents that his interest in Interlaken represents 3% of the equity, and that he will receive no remuneration from Interlaken or its affiliates in connection [**12] with this transaction other than from his existing investment in Interlaken.
>
> Interlaken Capital, Inc. ("Interlaken Capital"), a Delaware corporation with its principal place of business at 165 Mason Street, Greenwich, Connecticut, provides investment advice and management services to Investment Partners. William R. Berkley owns all of the capital stock of Interlaken Capital.

Third Amended Disclosure Statement at 31.

Several days prior to the hearing on confirmation of the third amended plan of reorganization, Interlaken Investment exercised an option it held to withdraw its offer, and no other plan is presently pending. The parties have jointly represented to the court that a decision on the Committee's and U.S. Trustee's objections to the Zolfo, Cooper and Weil, Gotshal fee applications, hearings on which were held just prior to Interlaken Investment's formal withdrawal of its offer, may aid in the formulation of a new plan. [2]

2 At the date of the hearing on the final fee applications, the pending plan of reorganization called for a finite sum to be available for administrative claims, a sum less than the total of pending fee applications. On the date of rendering this ruling, the court has no information as to whether there are, or will be, any unencumbered funds available to satisfy administrative claims. It is possible, therefore, that the fees allowed herein may be subject to further revision in light of these circumstances.

[**13] III.

ARGUMENTS OF THE PARTIES

The Committee, starting with the Bankruptcy Code's premise that court-approved professionals must be, and remain, disinterested and not hold or represent an interest adverse to the estate, contends that Cooper's purchase of an interest in Interlaken Investment on January 25, 1993 violated that premise. It further asserts Cooper's failure to [*804] notify the debtors of the conflict in interest thereby created until May 1993, and not to so notify the creditors and other parties-in-interest until November 1993 was prohibited conduct, and that Cooper's solution of simply not having a Zolfo, Cooper employee negotiate with Berkley after May 25, 1993 was entirely inadequate and inappropriate. The Committee argues that the court should not only deny Zolfo, Cooper its unpaid fees, but also require Zolfo, Cooper to disgorge all fees received since the inception of the case.

The Committee asserts that Weil, Gotshal failed in its obligation to the debtors' estate by not requiring that Cooper's involvement with Berkley and Interlaken Investment be brought to the attention of the creditor body and the court, and that on either of two occasions in June 1993 when Palmer [**14] addressed the court concerning, *inter alia,* a proper plan for the debtors, Palmer had the opportunity and should have disclosed Cooper's pecuniary interest in a new investor plan. The Committee requests that Weil, Gotshal be denied its unpaid fees, and fees previously paid disgorged by it.

The U.S. Trustee supports the Committee in its claim that there was a clear failure by Zolfo, Cooper to timely disclose Cooper's involvement with a potential purchaser and suggests that the court should deny "compensation at a minimum for the time period that the court determines that such disclosure should have been made to the court and parties in interest." U.S. Trustee Memorandum of December 6, 1993 at 10. Arthur J. Gonzalez, Acting U.S. Trustee, advised the court at the hearing that after submitting the matter to the General Counsel for the U.S. Trustee's Executive Office, it was decided not to support the Committee's argument that Weil, Gotshal had an independent duty to report the lack of disinterestedness of another professional.

Zolfo, Cooper contends it remained disinterested and held no adverse interest until Cooper learned on May 20, 1993 that Berkley intended to use Interlaken Investment [**15] as the entity to acquire an interest in the reorganized debtors. Zolfo, Cooper maintains that Cooper's May 21, 1993 letter to the Board was sufficient disclosure and that remaining in the case but removing itself from any further negotiations with Interlaken Investment was the proper action and acceptable to the Board. Zolfo, Cooper also argues that even if the court determines a potential conflict of interest arose at some point, the court, based on the equities of the case, should not deny Zolfo, Cooper any fees incurred prior to the end of May 1993. After May, Zolfo, Cooper, as well as Weil, Gotshal, performed services, but did not accrue fees in accordance with the conditions of Bank financing.

Weil, Gotshal argues that "no case law . . . supports" the committee's contention that Weil, Gotshal should be denied all compensation for failing to disclose Cooper's conflict of interest; that Weil, Gotshal "supported the board's designation of Bloom to negotiate the terms of any transaction"; and that Weil, Gotshal "did not breach any fiduciary obligations in these cases." Weil, Gotshal Memorandum of December 9, 1993 at 7-12.

IV.

DISCUSSION

A.

The Bankruptcy Reform Act of 1978, as amended, [**16] (Code), with its provisions requiring that all professionals whose employment is dependent upon court approval comply with high fiduciary standards, represents the considered judgment of Congress. In part due to the common-fund nature of bankruptcy estates, and in part to maintain and promote public confidence in the integrity of the bankruptcy system, Congress enacted strict standards by which a professional's performance is measured. *See In re EWC, Inc., 138 Bankr. 276, 279 (Bankr. W.D. Okla. 1992)*; *In re Consolidated Bancshares, Inc., 785 F.2d 1249, 1256 n.6 (5th Cir. 1986)* ("The standards for the employment of professionals are strict, for Congress has determined that strict standards are necessary in light of the unique nature of the bankruptcy process.").

The central provision is Code *ß 327(a)*, which states:

> The trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other [*805] 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 [**17] duties under this title.

11 U.S.C. ß 327(a). *Section 1107(a)* [3] makes *ß 327(a)* applicable to professionals retained by a debtor in possession in a chapter 11 case.

3 *Section 1107(a)* provides:

> Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in sections 1106(a)(2), (3), and (4) of this title, of a trustee serving in a case under the chapter.

11 U.S.C. ß 1107(a).

Fed. R. Bankr. P. 2014(a) supplements *ß 327(a)* with the following guidelines:

> (a) *Application for and Order of Employment.* An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to *ß 327*, ß 1103, or ß 1114 [**18] 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 persons 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, or 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.

Local R. Bankr. P. 24(a) further provides:

> In addition to the requirements set forth in *Bankruptcy* [**19] *Rule 2014*, all applications for the employment of professional persons shall state whether . . . the person has an interest adverse to the estate and the nature of that interest and whether . . . the person is disinterested within the meaning of *11 U.S.C. ß 101[14]*.

Section 328(c) provides the penalty if a professional person is not disinterested or holds an interest to the estate on the matter on which he/she is employed:

> The court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under *section 327* . . . if at any time person during such professional person's employment under *section 327* . . . such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed.

11 U.S.C. ß 328(c). "*Section 328(c)* acts retrospectively by telling those professionals whose retention under *ß 327(a)* was improper or who, during the case, failed to live up to the substantive requirements of *ß 327(a)* on an ongoing basis while working [**20] for the estate that they might lose some or all the compensation to which they might otherwise be entitled." *In re Diamond Mortgage Corp. of Illinois, 135 Bankr. 78, 89 (Bankr. N.D. Ill. 1990)*; *see also In re Tinley Plaza Assocs., L.P., 142 Bankr. 272, 278 (Bankr. N.D. Ill. 1992)* (conflicts arising after court approves employment must be immediately disclosed to the court).

"Disinterested person" is a defined term in the Code, [4] while adverse interest is not. [*806] Case law, however, generally holds that the phrase "to hold or represent an adverse interest" means:

> 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

In Re Tinley Plaza, 142 Bankr. at 277.

4 *Section 101. Definitions.*

In this title --

. . . .

(14) "disinterested person" means person that --

> (A) is not a creditor, an equity security holder, or an insider;
>
> (B) is not and was not an investment banker for any outstanding security of the debtor;
>
> (C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment or banker in connection with the offer, sale, or issuance of a security of the debtor;
>
> (D) is not and was not, within two years before the date of the filing of the petition a director, officer, or employee of the debtor or of an investment banker specified in subparagraph (B) or (C) of this paragraph; and
>
> (E) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or in-

> direct relationship to, connection with, or interest in, the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph, or for any other reason . . . .

11 U.S.C. ß 101(14).

[**21] The disinterested-person test and lack-of-adversity requirement obviously overlap. This court, following the strict constructionist rule of the Second Circuit, *see In re Futuronics Corp., 655 F.2d 463 (2d Cir. 1981)*, has previously held that violation of disclosure rules alone is sufficient to partially deny compensation regardless of whether an undisclosed fee arrangement was actually materially adverse to the interest of the estate. *See In re Kero-Sun, Inc., 58 Bankr. 770, 777-81 (Bankr. D. Conn. 1986)*. *See also In re Tinley Plaza, 142 Bankr. at 278* ("Failure to meet the requirements of *Rule 2014(a)* is enough by itself" to disqualify and deny compensation.); *In re Glenn Elec. Sales Corp., 99 Bankr. 596, 599 (D.N.J. 1988)* ("Reading *Rule 2014(a)* in conjunction with *Section 327*, it is clear that any employment arrangements which implicate adverse or non-neutral interests must be brought to the attention of the court."). *Cf. In re Status Game Corp., 102 Bankr. 19 (Bankr. D. Conn. 1989)* (Court will refuse approval of employment of [**22] attorneys for debtor in possession because of appearance of conflict where attorneys intend to continue representation of estate's major secured creditor in other matters.).

It is also well settled that

> *Section 328(c)* was placed in the Code to provide the court with an optional "penalty" for professionals who entered into a conflict of interest with the estate. Professionals employed for the estate are under a continuing duty to disclose their connections.
>
> . . . .
>
> . . . The disinterested requirement is intended to prevent even the appearance of conflict irrespective of the integrity of the person or firm under consideration.

In re EWC, 138 Bankr. at 282-84 (citations and internal quotations omitted). *See also In re Wiredyne, Inc., 3 F.3d 1125, 1127 (7th Cir. 1993)* ("The impartiality requirement of *sections 327* and *328* has been interpreted strictly, and a number of courts have held that the distinction between an actual conflict of interest and a potential conflict of interest is artificial.").

B.

Applying these concepts to the conduct of Zolfo, Cooper, the court concludes that at least by January 1993, Zolfo, Cooper [**23] became disinterested and held or represented an interest adverse to the debtors estates, and, thereafter, failed to make timely disclosure to the court and to the entire creditor body. Cooper's decision to invest $ 2 million in Interlaken Investment, an entity created and controlled by Berkley, when Berkley was in the process of becoming a bidder for the acquisition of the debtors, at the very least, created the appearance of a conflict with Zolfo, Cooper's professional duties in dealing with other potential acquirors. Despite Zolfo, Cooper's argument to the contrary, it is of little significance whether Berkley was negotiating on behalf of Interlaken Capitol or Interlaken Investment. It is also not material that Cooper believed that his investment amounted only to that of a "teeny, tiny limited partner," or that he would always act only with the best interests [*807] of the debtors' estates in mind. [5] *Cf. In re Envirodyne Indus., Inc., 150 Bankr. 1008, 1021 (Bankr. N.D. Ill. 1993)* ("No matter how trivial a connection appears to the professional seeking employment, it must be disclosed.").

> 5 Q. Do you recall when it was that you recused yourself?
>
> A. As soon as an offer was made. In fact, I think before an offer was made.Q. When you say recused yourself, what does that mean?
>
> A. Well, Berkley has a fund of which I am a teeny, tiny limited partner. In fact, I would characterize it something along the lines of the mutual fund where I am a passive investor, and I have no say in it.
>
> I don't know what they do today. I think my ownership percentage is in the area of two and a half percent.
>
> And when Berkley decided to make an offer, he decided to use this fund as the vehicle for whatever reason, and I am not aware of what reason he used.
>
> I immediately informed Weil Gotshal, the board of directors and the CEO that I had a very very small passive interest in this fund, and notwithstanding that, I had nothing to do with it, nothing to say about it, so on and so forth.
>
> And I believe I could have been a very effective negotiator, notwhithstanding that, but I de-

cided for the sake of appearances that I would immediately drop out of any discussions, negotiations, so on and so on and so on with the Berkley group, and I wrote a letter to the board informing them of that.

Cooper Deposition at 91-92.

[**24] The parties acknowledge that *ß 328(c)* vests the court with discretionary authority to deny fee applications in whole or in part in light of the statute's use of the word "may." *See In re Diamond Mortgage Corp., 135 Bankr. at 97*. The Committee contends the circumstances call for complete denial, including disgorgement of fees already received. The U.S. Trustee suggests partial denial, and Zolfo, Cooper argues for no denial, even if a violation on its part is found.

After weighing the various arguments of the parties, the court concludes the appropriate exercise of its discretion is to adopt in general the position of the U.S. Trustee. The court will partially deny Zolfo, Cooper's final fee application by taking into account that the disclosure, such as it was, was voluntarily made.

Through November 30, 1992, Zolfo, Cooper had been allowed and paid $ 1,443,075.82 as interim compensation for services and disbursements, representing 85% of the fees requested. There remains unpaid for that period $ 254,791.05. For the period starting December 1, 1992 and ending May 31, 1993, Zolfo, Cooper asks for $ 507,945.50 in compensation and $ 32,748.04 for reimbursement [**25] of expenses. The court hereby denies Zolfo, Cooper's application for all unpaid compensation and expenses, [6] and thus sustains the objections of the Committee and the U.S. Trustee in the amount of $ 795,484.59. [7]

6 At the hearing on its final fee application, Zolfo, Cooper had agreed to a $ 60,126.78 reduction in compensation for reasons unrelated to this ruling.

7 In its pre-hearing brief, but not at oral argument, the Committee contended that Cooper had purchased at least 26 weapons from Colt's for the sum of $ 43,000, in violation of 11 U.S.C. ß 154. Section 154 prohibits court officers from purchasing assets from a bankruptcy estate. Zolfo, Cooper's brief in response states that these purchases were under a Colt's Employee Sales Program and clearly not within the intent of ß 154. Zolfo, Cooper further noted that $ 37,000 of the $ 43,000 spent was for purchases on behalf of Berkley. The court is treating this issue as abandoned by the Committee in the absence of any record made at the hearing.

[**26] C.

The issue raised by the Committee's objection to the Weil, Gotshal fee application brings the court, according to both Weil, Gotshal and the U.S. Trustee, into uncharted waters. Weil, Gotshal contends in its memorandum responding to the Committee's objection that "There is no . . . authority which imposes upon an attorney a duty to disclose the potential conflicts of interest of another professional, particularly when that professional has himself disclosed the relevant information to the debtor and the debtor has taken effective steps to deal with the conflict." Weil, Gotshal Memorandum at 10.

The court, in section B, *supra,* has determined that Zolfo, Cooper's "disclosure" did not meet the standards imposed by the Code, and that the Board did not take "effective steps" when it simply complied with Cooper's suggestion to change negotiators. Weil, [*808] Gotshal's argument in this respect is not persuasive.

The Code contains a provision, which, if not directly on point, is sufficiently so as to give the court guidance on the question of Weil, Gotshal's responsibility to the debtors' estates. If a trustee had replaced the debtors in these cases, Code ß 326(d) would require the court [**27] to deny compensation [8] "to the trustee if the trustee failed to make diligent inquiry into facts that would permit denial of allowance under *section 328(c)* of the title or, with knowledge of such facts, employed a professional person under *section 327* of this title." It could have been reasonably anticipated that in light of the duties of an attorney for a debtor in possession, that no lower standard would be applied to such attorney with actual knowledge of another professional's loss of disinterestedness.

8 Unlike a trustee, a debtor in possession is not entitled to compensation. *See supra* note 3.

Weil, Gotshal nowhere argues that inadvertence, reliance on other professionals to handle the matter, pressure of other estate duties, or the like were the cause of its failure either to require Zolfo, Cooper to make full disclosure to the creditor body and the court or to advise the Board to take such action itself. The rule of law of no responsibility proposed by Weil, Gotshal, and concurred in by the U.S. Trustee, [**28] cannot be consonant with the fiduciary responsibilities imposed on bankruptcy estate professionals. The general concerns of the Code and the courts to promote public confidence in the integrity of the bankruptcy system are compelling reasons to apply a prophylactic rule in considering the extent of the fiduciary duties of an attorney for a debtor in possession.

The court concludes that Weil, Gotshal's considered refusal to have the matter of Cooper's disinterestedness brought before the court is a sufficient basis to reduce the compensation otherwise due Weil, Gotshal. Taking into account the newness of the issue, the court reduces the compensation otherwise allowed by $ 250,000.

IV.

CONCLUSION

The Zolfo, Cooper fee application is denied in the amount of $ 795,484.59 and allowed in the amount of $ 1,443,075.82.

The Weil, Gotshal fee application requests $ 2,210,767.66 compensation and $ 18,268.69 expense reimbursement, of which $ 763,122.91 for services and $ 47,192.50 expenses was previously paid as interim fees and expenses. Based upon objection by the U.S. Trustee, Weil, Gotshal has consented to a reduction of $ 30,411.00 in expenses, and $ 53,170.00 in compensation. The court, [**29] by this ruling, has ordered a further reduction of $ 250,000.00, making total deductions of $ 333,581.00, and leaving as allowed final compensation and expense reimbursement the sum of $ 1,995,455.31. Weil, Gotshal has already received the sum of $ 810,315.41, leaving the further sum of $ 1,185,139.94 approved, but not ordered paid at this time. It is

SO ORDERED.

Dated at Hartford, Connecticut, this 17th day of February, 1994.

ROBERT L. KRECHEVSKY, CHIEF BANKRUPTCY JUDGE

In re: FIBERMARK, INC., FIBERMARK NORTH AMERICA, INC., and FIBERMARK INTERNATIONAL HOLDINGS, INC., Debtors.

Chapter 11, Case # 04-10463, Jointly Administered

UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF VERMONT

2006 Bankr. LEXIS 4029

March 11, 2006, Decided

NOTICE: [*1] NOT FOR PUBLICATION

COUNSEL: For FiberMark, Inc., Debtor In Possession: Adam S. Ravin, D. J. Baker, David M. Turetsky, Rosalie Walker Gray, Skadden, Arps, Slate, Meagher & Flom LLP, Four Times Square, New York, NY; Edward J. Meehan, Skadden, Arps, Slate, Meagher & Flom LLP, Washington, DC; Jennifer Emens-Butler, Raymond J Obuchowski, Bethel, VT; Robert S DiPalma, Burlington, VT.

For U S Trustee, U.S. Trustee: Kevin Purcell, Kim F. Lefebvre, Office of the US Trustee, Albany, NY.

For Unsecured Creditors Committee, Unsecured Creditors Committee, Creditor Committee: Blossom Kan, Fred S. Hodara, Kenneth A. Davis, Kim Koopersmith, Mitchell P. Hurley, Akin Gump Strauss Hauer & Feld LLP, New York, NY; James B Anderson, Ryan Smith & Carbine LTD, Rutland, VT; Jonathon L. Gold, Akin Grump Strauss Hauer & Feld, LLP, Robert S. Strauss Building, Washington, DC.

JUDGES: Colleen A. Brown, United States Bankruptcy Judge.

OPINION BY: Colleen A. Brown

OPINION

MEMORANDUM OF DECISION

ON THE U.S. TRUSTEE'S MOTION FOR SUMMARY JUDGMENT AND ON CHANIN'S CROSS-MOTION FOR SUMMARY JUDGMENT

The cross-motions for summary judgment before the Court test the limits of the obligation of professionals to [*2] disclose "all connections" as a prerequisite to appointment under *FED. R. BANKR. P. 2014* ("*Rule 2014*"). The United States Trustee (the "UST") filed an objection to the third and final fee applications of Chanin Capital Partners, LLC ("Chanin"), the financial advisors and investment bankers to the former official committee of unsecured creditors (the "Committee"), asserting that Chanin's failure to disclose its connections to the members of the committee, and the attorneys and accountants appointed in this case constitutes a sanctionable violation of *Rule 2014*. Chanin counters that the UST's interpretation of the requirements of *Rule 2014* exceeds what any court has ever declared to be required, is inconsistent with practice in the community of bankruptcy professionals, and is not a reasonable basis for a monetary sanction against Chanin. For the reasons set forth below, the Court finds that the UST's interpretation of *Rule 2014* is not unreasonable, but the facts and circumstances presented do not warrant a dramatic reduction in Chanin's fees based on the alleged violation of *Rule 2014*.

JURISDICTION

The Court has jurisdiction over these summary [*3] judgment motions under *28 U.S.C. ßß 157(b)(2)(A)* and *1334*.

SUMMARY JUDGMENT STANDARD

Summary judgment is proper only if the record shows that there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law. See *FED. R. CIV. P. 56(c)*; *FED. R. BANKR. P. 7056*. A genuine issue exists only when "the evidence is such that a reasonable [trier of fact] could return a verdict for the nonmoving party." *Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 248, 106 S. Ct. 2505, 91 L. Ed. 2d 202 (1986)*; see also *Celotex Corp. v. Catrett, 477 U.S. 317, 106 S. Ct. 2548, 91 L. Ed. 2d 265 (1986)*. The substantive law will identify which facts are material. Only disputes over facts that might affect the outcome of the suit under the governing law will properly preclude the entry of summary judgment. See *Anderson, 477 U.S. at 247*. Factual disputes that are irrelevant or unnecessary are not material. See id. The court must view all the evidence in the light most favorable to the nonmoving party and draw all inferences in the nonmovant's favor. [*4] See *Cruden v. Bank of New York, 957 F.2d 961, 975 (2d Cir. 1992)*. In making its determination, the court's sole function is to determine whether there is any material dispute of fact that requires a trial. See *Anderson, 477 U.S. at 249*; see also *Palmieri v. Lynch, 392 F.3d 73, 82 (2d Cir. 2004)*; *Delaware & Hudson Ry. Co. v. Conrail, 902 F.2d 174, 178 (2d Cir. 1990)*, cert. denied, *500 U.S. 928, 111 S. Ct. 2041, 114 L. Ed. 2d 125 (1991)*.

THE UNDISPUTED FACTS

The parties have filed a Joint Statement of Undisputed Material Facts (doc. # 2186) that sets forth the following pertinent facts. [1]

> 1 The Court has condensed the undisputed facts identified by the parties, but sets forth in full the quotations from the Chanin disclosures that the parties have identified as material, since the sufficiency and circumstances of these disclosures are precisely what are at issue herein.

1. On March 30, 2004, the Debtors filed voluntary petitions under chapter [*5] 11 in this Court.

2. On April 4, 2004, the UST appointed an Unsecured Creditors' Committee.

3. Although there were a few changes in the composition of the Committee from time to time, at all times relevant to this matter, AIG Global Investment Group, Inc. ("AIG"), Wilmington Trust Company ("Wilmington"), Post Advisory Group, LLC ("Post") and Silver Point Capital, L.P. ("Silver Point") were members of the Committee.

4. The Committee hired Chanin to serve as its financial advisor on or about April 7, 2004 and on May 7, 2004 the Committee filed an application requesting appointment of Chanin (doc. # 216, the "Application").

5. Mr. Skip Victor of Chanin filed an affidavit in support of the Application (the "Victor Affidavit") representing that Chanin had performed the following review, in accordance with the requirements of *Rule 2014* and *11 U.S.C. ß 1103(b)*:

> Chanin has conducted a conflicts search and made due inquiry regarding its connections and relations with the members of the Committee, the Debtors, their board of directors, their creditors of record, their equity shareholders, and the attorneys and accountants of each of the foregoing, [*6] the Office of the United State Trustee, and the Honorable Colleen A. Brown to determine whether it has any conflicts of interest or other relationships that might bear on its employments. In addition to other inquires, Chanin has researched its client files and records that contain relevant information and that have been retained in the normal course of business. In connection with this search, Chanin obtained from the Committee the names of certain individuals and entities that may be parties-in-interest in these bankruptcy cases (all of the persons and entities identified in this paragraph, the "Potential Parties-In-Interest"). To the best of my knowledge, information, and belief, and after due

inquiry, neither I nor Chanin, nor any professional employee of Chanin has any connection with a Potential Party-In-Interest.

The Victor Affidavit stated that -- following the foregoing inquiry -- the affiant had concluded that Chanin

(i) does not have any connection with the Debtors, the Debtors' creditors, their respective attorneys and accountants or any other parties-in-interest (as reasonably known to us),

(ii) pursuant to *11 U.S.C. section 1103(b)*, does [*7] not provide advisory services to any other entity having an adverse interest in connection with these cases and

(iii) is "disinterested" as that term is defined in *section 101(14) of the Bankruptcy Code*.

See doc #. 2186, par. 4.

6. The Victor Affidavit also contained the following language, describing the parameters of the preceding disclosures:

"[t]o the best of my knowledge, information and belief, and after due inquiry, Chanin has not been retained to assist any person or entity other than the Committee on matters relating to these bankruptcy cases. If the Application is approved by the Court, Chanin will not accept any engagement or perform any services in these bankruptcy cases for any person or entity other than the Committee. Chanin, however, will continue to provide services that do not relate to these bankruptcy cases to persons or entities that may be Potential Parties-In-Interest." . . . "Except as described above, to the best of my knowledge, information and belief, and after due inquiry, neither I, Chanin, nor any professional employee of Chanin represents or holds an interest of the Debtors' bankruptcy estates or their creditors. [*8] " . . . "I am not related or connected to and, to the best of my knowledge, information and belief, and after due inquiry, no[] other professional of Chanin is related or connected to the Honorable Colleen A. Brown." . . . "[e]xcept as described herein, neither Chanin nor, to the best of my knowledge, any employee of Chanin is or was a creditor or equity holder of the Debtors." . . . "Neither Chanin nor to the best of my knowledge, any employees of Chanin is or was a consultant or advisor for any outstanding security of the Debtors." "Neither Chanin nor to the best of my knowledge, any employees of Chanin is or was within two years before the commencement of these cases, a director, officer or employee of the Debtors or an investment banker of the Debtors." . . . "The debtors have numerous relationships with third parties and creditors. Consequently, although every reasonable effort has been made to discover and eliminate the possibility of conflict, including the efforts outlined above, Chanin is

> unable to state with certainty whether one of its clients or an affiliated entity holds a claim or otherwise is a party-in-interest in these chapter 11 cases. If Chanin discovers any information [*9] that is contrary to or pertinent to the disclosures made herein, Chanin will promptly disclose such information to the Court on notice to the United States Trustee and other appropriate parties."
>
> See doc #. 2186, par. 4.

7. On June 14, 2004, the Court entered an order authorizing retention of Chanin as financial advisor and investment banker to the Committee, pursuant to *11 U.S.C. ß 327(a)*.

8. On or about May 13, 2005, the UST filed an objection to the Third Interim Fee Application of Akin Gump Strauss Hauer & Feld LLP ("Akin"), attorneys for the Committee, which asserted, among other things, that Akin had not met its duty to timely inform the Court of all its "connections" with parties in the case. See doc # 1469 at par. 4.

9. This prompted Chanin to undertake a further review and supplement certain information set forth in the Victor Affidavit.

10. On June 13, 2005, Chanin filed a second affidavit ("Victor Supplemental Affidavit") that supplemented the Victor Affidavit by reciting certain items respecting certain Potential Parties-In-Interest in these chapter 11 cases. Those items included the following:

> Committee Members. [*10] Chanin has represented official, ad hoc, or steering committees in unrelated matters, in which parties in interest in this case have been parties in interest, including in capacities as members of such aforementioned committees. They include:
>
> *a. Silver Point Capital. L.P. ("Silver Point")* Chanin acted as financial advisor to the Unsecured Creditors' Committee for iPCS, wherein Silver Point acquired securities in the latter stages of the case but did not participate as a member of the Committee. Chanin acted as financial advisor to an ad-hoc committee of noteholders of Trump Casino Holdings ("TCH"), wherein Silver Point at times was a member of the ad-hoc committee. Chanin acted as financial advisor to an ad-hoc committee of secured lenders for Pegasus Satellite Television, wherein Silver Point was a member of the unsecured creditors' committee. Chanin acts as financial advisor to the Lease Indenture Trustee and Pass Through Trustee for MIRMA wherein Silver Point is an interested party. Chanin acted as financial advisor to the unsecured creditors' committee for RCN Corp., wherein Silver Point was a member of the bank group steering committee.
>
> *b. AIG Global Investment Group.* [*11] *("AIG")* Chanin acted as financial advisor to the unsecured creditors' committee for Venture Holdings wherein AIG was a committee member. Chanin acted as financial advisor to an ad-hoc committee of noteholders in IWO Holdings wherein AIG was a member. Chanin acted as financial advisor to the unsecured creditors' commit-

tee for iPCS, wherein AIG acquired securities in the latter stages of the case but did not participate as a member of the committee. Chanin acted as financial advisor to an ad-hoc committee of noteholders for US Unwired, wherein AIG was a committee member. Chanin acted as financial advisor to an ad-hoc committee for Alamosa Holdings, wherein AIG was an interested party. Chanin acted as financial advisor to an ad-hoc committee of noteholders for American Cellular, wherein AIG was a member. Chanin acts as financial advisor to the equity committee for Adelphia, wherein AIG DKR Sound Shore Funds is a member. Chanin acts as financial advisor to the ad hoc committee of noteholders of Allied Holdings, wherein AIG is a member of the ad hoc committee.

c. Post Advisory Group ("Post") Chanin acts as financial advisor to the unsecured creditors' committee for Venture Holdings, [*12] wherein Post was a member of a pre-petition ad-hoc committee of noteholders. Chanin acted as financial advisor to an ad-hoc committee of noteholders for Merrill Corporation, wherein Post was a member. Chanin acted as financial advisor to an ad-hoc committee of noteholders for Denny's, wherein Post was an interested party.

d. Wilmington Trust Company ("Wilmington Trust") Chanin acted as financial advisor to the unsecured creditors' committee in Global Crossing, wherein Wilmington Trust was a member.

e. E.I. DuPont de Nemours & Co. ("DuPont") Chanin acted as financial advisor to the unsecured creditors' committee in Global Crossing, wherein DuPont Capital Management was a member.

Professionals. Chanin has worked with (or opposite) many of the professionals involved in this case. They include:

a. Akin Gump Strauss Hauer & Feld LLP ("Akin Gump") Chanin acts as financial advisor to the equity committee for Adelphia, wherein Akin Gump was counsel to a member of an adhoc creditors committee. Chanin acted as financial advisor to the unsecured creditors' committee for Venture Holdings, wherein Akin Gump was counsel for the Committee. Chanin acted as financial advisor [*13] to the secured lender Steering Committee for Pegasus Satellite Communications, wherein Akin Gump was counsel to the unsecured creditors' committee. Chanin acts as financial advisor to the adhoc high yield bondholders committee for Satelites Mexicano ("SatMex"), wherein Akin Gump is the ad-hoc committee's counsel. Chanin has been selected as the financial advisor to the unsecured creditors' committee for Collins and Aikrnan, wherein Akin Gump is the committee's counsel. Chanin acts as the financial advisor to the equity committee of Loral Space and Communications, wherein Akin is an advisor to the Official Committee of Unsecured Creditors for the company.

b. Skadden Arps Slate Meagher & Flom, LLP ("Skadden") Chanin acts as financial advisor to the Lease Indenture Trustee and Pass Through Trustee for MIRMA, wherein Skadden was counsel to the company (prebankruptcy). Chanin acted as financial advisor to the unsecured creditors' committee for GenTek, wherein Skadden was counsel to the debtors. Chanin acted as financial advisor to the unsecured creditors' committee for RCN, wherein Skadden was counsel to the debtors. Chanin acted as financial advisor to an ad hoc committee of noteholders [*14] in Alamosa Holdings, wherein Skadden was counsel to the company. Chanin acted as financial advisor to the TCH noteholder committee, wherein Skadden represented DLJ Merchant Banking in the transaction. Chanin represented the Official Committee of Unsecured Creditors in HQ Global Workplaces; Skadden represented the Debtor. Chanin acted as financial advisor to the Official Creditors Committee of Washington Group International, wherein Skadden was counsel to the Debtor. Chanin acted as financial advisor to the official committee of unsecured creditors for Color Spot, wherein Skadden was counsel to a member of the Official Committee of Unsecured Creditors. Chanin acted as financial advisor to the Official Committee of Unsecured Creditors of RCN, wherein Skadden acted as counsel to the company. Chanin acted as financial advisor to the Official Committee of Unsecured Creditors of Stone and Webster, wherein Skadden was counsel to the company. From 1986 to March 1990, Russ Belinsky, a Senior Managing Director and cofounder of Chanin Capital Partners was an Associate in the Los Angeles office of Skadden.

c. Greenhill & Co., LLC ("Greenhill") Chanin acted as financial advisor to the Secured [*15] Lender Steering Committee for Pegasus Satellite Communications, wherein Greenhill was the financial advisor to the unsecured creditors' committee, Chanin acts as the financial, advisor to the equity committee of Loral Space and Communications, wherein Greenhill acts as the company's financial advisor. Chanin acts as financial advisor to the equity committee for Adelphia, wherein Greenhill is the financial advisor to the unsecured creditors committee. Chanin advised the unsecured creditors committee in the Cable and Wireless United States Chapter 11case, wherein Greenhill represented the Debtors.

d. Weil Gotshal & Manges LLP ("Weil") Chanin acts as financial advisor to the Lease Indenture Trustee and Pass Through Trustee for

MIRMA, wherein Weil is counsel to the unsecured creditors' committee. Chanin acts as financial advisor to the equity committee for Adelphia, wherein Weil is counsel to Adelphia. Chanin acted as financial advisor to the ad-hoc committee of noteholders in IWO Holdings; Weil represented the company. Chanin acted as financial advisor to the unsecured creditors' committee in Global Crossing, wherein Weil was counsel to the debtors. Chanin acts as financial advisor [*16] to the equity committee for Footstar; wherein Weil is counsel to the debtors. Chanin acts as the financial advisor to the equity committee of Loral Space and Communications, wherein Weil represents the company. Chanin acted as financial advisor to Home Interiors and Gifts, wherein Weil was counsel to the company.

e. Wilmer Cutler Pickering Hale and Dorr LLP ("Wilmer") Wilmer has served as counsel to Verizon in Adelphia, ATX and Global Crossing. Wilmer has served as counsel to Chanin in connection with fee and retention issues in TCH, LEAP, Loral, Borden Chemicals and Atlantic Express. Wilmer serves as counsel to the Floating Rate Noteholders in SatMex; Chanin serves as financial advisor to Ad Hoc Committee of SatMex high yield noteholders.

The Debtors. Chanin has not provided any prior services to the Debtors or to their affiliated entities. None of this work was related to the Debtors or their affiliated entities in any way, and many of these engagements have concluded (or are near conclusion).

See doc. # 2186 par 7.

11. The Victor Supplemental Affidavit further states

Chanin has conducted a revised and exhaustive conflicts search and made diligent due inquiry [*17] regarding its connections and relations with the members of the Committee, the Debtors, their board of directors, their creditors of record, their equity shareholders, and the attorneys and accountants of each of the foregoing, the Office of the United States Trustee, and the Honorable Colleen A. Brown to determine whether it has any conflicts of interest or other relationships that might bear on its retention or disinterestedness. Indeed, Chanin has researched its client files and its records that contain relevant information and that have been retained in the normal course of business. Chanin obtained from the Committee the names of certain individuals and entities identified in this paragraph, the "Potential Parties-In-Interest"). To the best of my knowledge, information and belief, and after due inquiry, and except as stated below, neither I, Chanin, nor any professional employee of Chanin has any connection with

Potential Parties-In- Interest.

The Victor Supplemental Affidavit did not state that any of the relationships recited in Paragraph 5 of the Victor Supplemental Affidavit constituted "connections" within the meaning of *Bankruptcy Rule 2014*. To the contrary, Paragraph 4 [*18] further stated, "Except as otherwise set forth herein, to the best of my knowledge, Chanin

(i) does not have any connection with the Debtors, the Debtors' creditors, their respective attorneys and accountants or any other party-in-interest (as reasonably known to us),

(ii) pursuant to *11 U.S.C. [s]ection 1103(b)*, does not represent any other entity having an adverse interest in connection with these cases, and

(iii) is "disinterested" as that term is defined in *section 101(14) of the Bankruptcy Code*."

See doc. # 2186 par 7.

12. Chanin filed a second supplemental disclosure on August 1, 2005 that identified several instances in which members of the former Committee, or retained professionals of the Committee, are involved in cases in which Chanin was recently selected to serve as financial advisor to an ad hoc noteholders' committee for Salton. Chanin did not state that its retention to serve as financial advisor to the Salton ad hoc noteholders' committee constituted a connection or constituted a relationship that might bea on its retention or disinterestedness. See doc. # 2186, par 8, 9.

13. On June 23, 2005, the [*19] UST filed an objection to Chanin's third interim fee application, questioning the adequacy of Chanin's disclosures under *Rule 2014*. The Court entered an Order deferring consideration of the subject application and objection until after Chanin filed its final fee application. Chanin filed it final fee application on September 9, 2005, and a supplement thereto on January 19, 2006. The UST filed an objection to the final fee application on February 6, 2006 seeking an order "substantially reducing Chanin's compensation." See doc. # 2186, par. 10 - 12.

14. On April 19, 2005, upon the consent of all parties present, the Court entered an order directing the UST to appoint an examiner in these cases to investigate the following matters:

a. the transfer of the Debtors' executives' claims, including but not limited to, the claims of Alex Kwader, and other persons who were employees of the Debtors at the time of the transfer of their claim(s), to Silver Point Capital, L.P. ("Silver Point"), the nature and extent of the disclosure of those transfers and whether breach(es) of fiduciary duties to the estate resulted;

b. the transfer of the claim of former committee member Solutions [*20] Dispersions, Inc. to Silver Point;

c. the quality of the "screening wall" Silver Point, and the other members of the Creditors' Committee, established in accordance with this Court's Order Approving Specified Information Blocking Procedures and Permitting Trading in Securities of the Debtors Upon Establishment of a Screening Wall (doc. # 684) (the "Trading Order"), whether it was breached, and whether the Trading Order was violated;

d. the dispute among Committee members regarding corporate governance issues and whether any Committee member breached its fiduciary duty to act in the best interest of all creditors; and

e. any other matter the Examiner deems necessary and relevant to the complete and full investigation of the four enumerated areas included herein.

By order dated April 22, 2005, the Court approved the United States Trustee's selection of Harvey R. Miller as the examiner. On July 11, 2005, the examiner filed his report under seal. The Court ordered the report unsealed with some redactions by order dated August 16, 2005. See doc. # 2186, par. 12.

15. On July 13, 2005, after release of the Examiner's Report, the UST disbanded the Committee. See doc. # [*21] 1638.

DISCUSSION

1. Summary Judgment is Proper

The issue before the Court is whether Chanin's fees should be drastically reduced because it failed to comply with the requirements of *Rule 2014*, by failing to list all connections it had with parties in interest in this case, and in particular, by failing to disclose all cases in which it had previously been involved where other parties or professionals from the Fibermark cases had also been involved. The Court finds that the parties have stipulated to all facts material to that issue, that there are no material facts in dispute, that summary judgment is proper and that the record is sufficient for the Court to make a determination on the cross-motions for summary judgment as a matter of law.

2. The Requirements of Rule 2014

Rule 2014(a) provides

> (a) APPLICATION FOR AN ORDER OF EMPLOYMENT. An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to *ß 327*, *ß 1103*, or *ß 1114* of the Code shall be made only on application of the trustee or committee. . . . The application shall state the specific facts showing the necessity for [*22] the employment, the name of the person to be employed, the reasons for the selection, 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 accountant, 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 Stares trustee, or any person employed in the office of the United States trustee.**

FED. R. BANKR. P. 2014(a) [emphasis added]. Neither party disputes that all professionals appointed in this bankruptcy case were under an obligation to comply with *Rule 2014*. The issue is what "connections" must be disclosed. The term "connections" is not defined in the Bankruptcy Code or Rules. The case law is consistent in requiring parties to comply with the disclosure requirements of *Rule 2014*, and punishing parties who fail to comply, but no case has considered [*23] whether the deficiency identified by the UST constitutes a failure to meet the requirements of *Rule 2014*. The UST argues that Chanin's obligation to disclose all connections encompassed an obligation to disclose all cases in which it was involved where a party or professional in this case was also involved, regardless of whether there was any pecuniary or attorney-client or adversarial relationship. There is no case that either party or the Court has located which addresses whether this level of disclosure is envisioned by the Rule.

The Rule is very broad and was enacted to implement the appointment of professionals under *ß 327*, *ß*

1103, and *ß 1114 of the Bankruptcy Code*, and in particular to provide a mechanism for ensuring the disinterestedness of such professionals. The questions are how far is it reasonable to assume the rule was intended to go and by what factors, if any, the strict construction of the rule be tempered.

3. The Role of the U.S. Trustee in Monitoring Professionals in Chapter 11 Cases

Under the Bankruptcy Code, the U.S. Trustee has the duty of "monitoring all applications filed under [*24] *ß 327* of title 11." Thus, it is essential for the U.S. Trustee to police professional appointments pursuant to *ßß 327* and *1103* to guarantee the continuing integrity of the bankruptcy system. As Judge Friendly so eloquently stated in *In re Ira Haupt & Co., 361 F.2d 164, 168 (2d Cir. 1966)*, "the conduct of bankruptcy proceedings not only should be right but must seem right." In order to maintain the integrity of the bankruptcy process, it is essential for the U.S. Trustee to meet his or her mandatory duty to monitor all applications for professional appointment, and to guarantee that the professionals seeking employment have fully and properly submitted a "verified statement ... setting forth the person's connections" to the debtor, creditors and any other party in interest. *Fed.R.Bankr.P. 2014(a)*. Under *Rule 2014(a)*, it is the responsibility of the professionals to affirmatively disclose their connections. While it is not the duty of the U.S. Trustee to seek out connections between professionals seeking employment and parties who have an interest in the bankruptcy case, as the "watchdog" of the bankruptcy process it is proper for the [*25] U.S. Trustee to exercise his or her judgment on a case by case basis and to request further detail in the *Rule 2014* disclosures when the facts or circumstances of a particular case suggest this to be prudent or necessary. [2]

> 2 Through the administrative aspects of the case, as well as the U.S. Trustee's geographical region jurisdiction, the U.S. Trustee may well be privy to circumstances that affect the level disclosure warranted in a particular case that would not be evident or available to the Court or other parties in interest.

In this case, on the consent of all parties, the Court appointed an Examiner to investigate allegations of breaches of fiduciary duty by certain professionals, intercreditor disputes, illegal claims trading and other improper conduct by parties in interest. In light of these allegations and the appointment of an examiner, this case might be designated as one where a greater level of scrutiny of the connections among the professionals, or between the professionals and parties in interest, [*26] would be warranted. There is nothing in the record, and no material fact stipulated, to indicate that the U.S. Trustee requested disclosures from Chanin beyond the level of connection Chanin had already provided.

4. The Role of the Court and the Applicant Under Rule 2014

Courts have an obligation to construe *Rule 2014* very strictly because it is the courts' responsibility to determine whether a professional shall be disqualified due to their connection to a party in interest. *Diamond Lumber Inc. v. Unsecured Creditors' Committee of Diamond Lumber, Inc., 88 B.R. 773, 777 (N.D. Tex. 1988)*. "All facts that may be pertinent to a court's determination of whether a professional is disinterested or holds an adverse interest to the estate must be disclosed." *In re Haldeman Pipe & Supply Co., 417 F.2d 1302, 1304 (9th Cir. 1969)*. The decision as to what facts may be relevant should not be left up to the professional, "whose judgment may be clouded by the benefits of the potential employment." *In re Lee, 94 B.R. 172, 177 (Bankr. C.D. Cal. 1988)*. In light of the court's responsibility to approve the employment of professional, the [*27] disclosure requirements of *Rule 2014(a)* are broader than those governing inquiries into disinterestedness under *ß 327*. *In re Leslie Fay Cos., 175 B.R. at 536*. Code *ß 327* limits employment of professionals to those individuals who do not hold a interest that is materially adverse to the estate, while *Rule 2014* requires professionals to list all "connections" that they may have with a party to the proceeding. *Id.*

It is the responsibility and duty of the professional, however, and not the court, to make sure all "connections" have been disclosed. *Leslie Fay Companies, 175 B.R. at 533*. "Absent the spontaneous, timely and complete disclosure required by *section 327(a)* and *Fed.R.Bankr.P. 2014(a)*, court appointed counsel proceed *at their own risk*." *Rome, 19 F.3d at 59*. The purpose of *Rule 2014(a)* is to ensure that all facts relevant to a party's professional qualification are before the court so the presiding judge can determine whether the connections disqualify the applicant or if further inquiry into the matter is required. "The professional's duty to disclose is self-policing." *Granite Partners, 219 B.R. at 35*. [*28] It is not the duty of the court, the U.S. Trustee or any other party to search beyond the 2014(a) disclosure for the existence of connections that a professional seeking to be employed should have disclosed. Full disclose of all connections to a party in interest is the affirmative duty placed on the professional seeking employment. The duty to disclose all possible connections is so vital to the bankruptcy process that failure to do so is an independent basis for the disallowance of fees. See *In re Futuronics Corp., 655 F.2d at 469*; *In re Arlan's Dep't Stores, Inc., 615 F.2d at 933*; *In the Matter of Roger J. Au & Son, Inc., 71 B.R. 238, 242 (Bankr. N.D. Ohio 1986)*; *In re Tinley Plaza Associates, L.P., 142 B.R. 272, 278 (Bankr.*

N.D.Ill. 1992). Thus, professionals who seek appointment owe the duty of complete disclosure of all "connections" that bear upon their eligibility for such appointment.

5. The Plain Language of the Rule Must be Balanced Against the Importance of Attracting Competent Professionals to Bankruptcy Practice

The decision by the drafters of the Bankruptcy Rules to use the term "connections" in *Rule 2014(a)* [*29] is indeed "an unfortunate one." 9 L. King, *Collier on Bankruptcy, P 2014.05* (15<th> ed. 2005). It is difficult to comprehend how the drafters intended this to be enforced without any clarification as to the definition of the term, its breadth or the time period covered. As Chanin indicated at oral argument, the bankruptcy bar in the Northeast is a small one, thereby making it more likely than not that those bankruptcy practitioners at the larger firms of that region have all had some form of contact with one another over the course of their careers. [3] The Rule states that "all connections" to the parties in interest must be disclosed. Thus, the UST's interpretation of the plain language of the statute is not unfounded. It can indeed be argued that the "connections" a professional had with entities that are parties in interest in the instant case, by virtue of parallel involvement in other cases, no matter how remote, must be disclosed under *Rule 2014*.

3 This is even more pronounced in Vermont, where one must presume that the small number of bankruptcy professionals who handle bankruptcy matters will all inevitably deal with each of the other bankruptcy professionals in the state on a regular basis.

[*30] However, in light of the relatively small community of bankruptcy professionals in each tier of bankruptcy work and the high likelihood of coincident involvement of those bankruptcy professionals, that interpretation could impose an extra and significant burden on applicants, especially with regard to the disclosure of connections to other attorneys and accountants. If the UST's interpretation of the *Rule 2014* requirements were adopted, the volume of disclosure, and amount of time required to maintain the records and conduct the case by case investigation, for each appointment could outweigh the benefit of the appointment. Thus, it seems that such an interpretation, if strictly enforced, could have the effect of discouraging qualified professionals from seeking or accepting appointment in bankruptcy cases. This is an important consideration to weigh when assessing how far the net created by the term "connections" should extend. There is historical support for this consideration. When the Bankruptcy Code was enacted and the provisions regarding professional appointment were drafted, Congress made clear that it intended to "provide sufficient economic incentive [to lure competent bankruptcy [*31] specialists] to practice in the bankruptcy courts." *In re Busy Beaver Bldg. Ctrs., 19 F.3d 833, 850 (3d Cir. 1994)*, citing *In re McCombs, 751 F.2d 286, 288 (8th Cir. 1984)*. "The unambiguous policy inspiring *ß 330(a)*, expressed most clearly in the House Report accompanying House Bill 8200, H.R. 8200, 95<th> Cong., 1<st> Sess. (1977), is that professionals and paraprofessionals in bankruptcy cases should earn the same income as their non-bankruptcy counterparty." Id. If professionals seeking employment in bankruptcy cases are required to disclose every connection, no matter how trivial or remote, the costs of such disclosure could drive qualified professionals out of the bankruptcy practice. Nonetheless, "*Rule 2014* disclosure requirements are to be strictly construed." *In re The Leslie Fay Companies, Inc., et al., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994)*; see *In the Matter of Arlan's Dep't Stores, Inc., 615 F.2d 925, 933 (2d Cir. 1979)*; *Futuronics Corp. v. Arutt, Nachamie & Benjamin (In the Matter of Futuronics Corp.), 655 F.2d 463, 469 (2d Cir. 1981)*; *In re Rogers-Pyatt Shellac Co., 51 F.2d 988, 992 (2d Cir. 1931)*. [*32] The mandatory disclosure requirements allow courts to make an informed determination of whether the retention of a professional should be approved. *In re Granite Partners, L.P., 219 B.R. 22, 35 (Bankr. S.D.N.Y. 1998)*; *Rome v. Braunstein, 19 F.3d 54, 59 (1st Cir. 1994)*.

A distinction must be made between situations and involvement in other cases that are disclosed just because they could conceivably fit within the broadest definition of connections and those that suggest an appearance of a conflict of interest or lack of disinterestedness. There is no question that any connection that might reasonably be perceived to constitute a conflict of interest, or to support a determination that the applicant is not disinterested, must be disclosed. A professional seeking to be employed in a bankruptcy case should disclose all arguable conflicts, even if it is only to explain them away. See *In re eToys, Inc., 331 B.R. 176 (Bankr. D. Del. 2005)*, *In re EWC, Inc, 138 B.R. 276 (Bankr. W.D. Okla. 1992)*, It is the former category of disclosures that is in question herein.

This Court will weigh an applicant's obligation to disclose connections [*33] with other professionals and parties in interest in the case -- where such connections are not attorney-client relationships, pecuniary relationships, or adversarial relationships -- against the burden that this obligation will impose, on a case by case basis. It will continue to rely on the U.S. Trustee and other parties in interest to move for additional disclosure when those parties have reason to believe that the additional level of disclosure is warranted to ensure the disinterestedness of all professionals appointed in bankruptcy cases. When there is any doubt as to whether the disclosure is necessary, the U.S. Trustee, the Court and the applicant should err on the side of caution. In this regard the Court finds instructive the words of its sister court:

> Therefore, the better practice for *Rule 2014* disclosure is to err, if at all, on the side of over-disclosure. Disclosure is the cornerstone of the retention process. The process places a burden upon the applicant to disclose and a burden upon the United States Trustee, and other parties in interest, to raise their concerns in a timely manner. . . .A review of [the movant's] motion reveals that it seeks disqualification [*34] of Milbank based upon a failure to disclose--not connections as required under 2014--but a failure to disclose every conceivable interpretation of its connections . . .[The movant's] view of disclosure requirements as seen through its criticism of Milbank would make disclosure under *Rule 2014* an impossible task

In re Enron Corp., (Bankr S.D.N.Y, 2002) 2002 Bankr. LEXIS 1720, 2002 WL 32034346 at 5. While the facts of the *Enron* matter in question are distinguishable from those at bar, and the UST's interpretation is more founded in sound statutory interpretation than the movant in the cited proceeding, the Court's logic is, nonetheless, applicable.

6. Chanin's Continuing Obligation to Disclose

Rule 2014(a) does not expressly require professionals employed by the estate to supplement or continue filing updated disclosure statements throughout their employment. Professionals employed for the estate however, are under a continuing duty to disclose connections that might bear on the professional's qualification for retention throughout their employment. *In re Diamond Mortg. Corp. of Illinois, 135 B.R. 78, 89 (Bankr. N.D.Ill. 1990)*. *Section 327(a)* of the bankruptcy [*35] code "implies a duty of continuing disclosure, and requires professionals to reveal connections that arise after their retention." *Granite Partners, 219 B.R. at 35*. If a professional employed for the estate enters into a relationship that creates a conflict of interest with the estate, that conflict must be disclosed and immediate disqualification is required by *ß 327(a)*. *In re EWC, Inc., 138 B.R. 276, 282 (Bankr. W.D. Okl. 1992)*; *Tinley Plaza Associates, 142 B.R. at 278*. "Continuing disclosure is necessary to preserve the integrity of the bankruptcy system by ensuring that the trustee's professionals remain conflict free." *Granite Partners, 219 B.R. at 35*.

Hence, Chanin had an ongoing obligation to disclose its connections and address factors which might bear on its disinterestedness, for example, when new professionals (such as the examiner or his counsel) were appointed to participate in the case. The UST has raised important questions about whether Chanin met its disclosure obligations in this regard. The Court does not find that the UST has presented sufficient proof to warrant a drastic or substantial reduction [*36] in Chanin's fees based on a failure to make continuing disclosures, however, it is a factor the Court will consider when making a final determination on Chanin's pending fee applications.

7. Due Process Considerations

The UST's request for sanctions raises a due process question. This Court is duty bound to impose sanctions or reduce fees when professionals breach their legal, statutory or ethical obligations. However, it will not do so if the party is not on reasonable notice of those obligations. There is no case law under *Rule 2014*, or legislative history, that elucidates the definition of "connections" in a way that either supports or refutes the interpretation that the UST urges. The plain language of the statute would support the UST's interpretation but even the UST cannot point to a single instance where this interpretation was argued or adopted. The facts of the instant case are not unique. It is quite typical for a bankruptcy professional who works primarily in chapter 11 cases to have dealt with the other bankruptcy professionals in any particular case, on many previous occasions. In the absence of any proof that the interpretation being pressed by the UST has [*37] been imposed in other chapter 11 cases, or that the professionals in this case, and Chanin in particular, was on notice that failure to comply with this very high level of disclosure could result in sanctions, the Court finds the imposition of drastic reductions based upon this newly announced deficiency would be a violation of due process principles. This determination is not tantamount to a finding that the disclosure was adequate or that the UST position is unwarranted, either in general or in this case. It is, rather, a determination that due process rights are paramount and that sanctions will not be imposed for a rule violation against a party who did not have notice of the rule's requirements. Sanctions imposed by that sort of ambush serve no legitimate purpose.

CONCLUSION

For the reasons set forth above, the Court finds that there are no material facts in dispute and summary judgment is proper. The Court further finds that *Rule 2014* does require professionals appointed in chapter 11 cases to disclose all connections with the debtor, creditors, any other party in interest, as well as the attorneys and accountants for such parties. However, the extent and format of [*38] such disclosures may vary from case to case, as the circumstances of each case will define the "connections" that must be disclosed to provide the Court and parties in interest with sufficient information to determine whether the applicant is disinterested. Moreover, any determination of the sufficiency of the disclosures produced pursuant to *Rule 2014* should be made by balancing the plain language of the rule's mandate that applicants disclose "all connections," in order to maintain integrity of the professional appointment process in bankruptcy cases, against the common sense analysis of what connections are reasonably defined as pertinent to the ultimate question of disinterestedness, so that competent professionals do not find the requirements of representing parties in bankruptcy cases so burdensome as to deter them from doing so. If an applicant conceals, fails to disclose or mischaracterizes connections that are pertinent to the disinterestedness inquiry, or refuses to produce the more detailed data reasonably requested by the UST, this Court would consider disallowance of all fees to be an appropriate sanction. However, the Court will not retroactively impose this sanction [*39] if the applicant did not have notice or a reasonable expectation, that a greater level of detail was required in the instant case.

The UST's motion for summary judgment seeks an Order (a) declaring that Chanin failed to disclose all of its connections and that the disclosures it filed do not satisfy the requirements of *Rule 2014*, *(b)* sustaining its objection to Chanin's fee applications, (c) denying a substantial portion of the fees Chanin seeks in it final application because of the *Rule 2014* disclosure deficiencies, and (d) denying the fees Chanin seeks for legal services provided to it by Wilmer, Cutler. The Court finds that *Rule 2014* may require a level of disclosure that is not inconsistent with the position argued by the UST, but that it is not required in every case, and though it would not have been inappropriate for the UST to seek this greater level of disclosure in this case, from all professionals, there is nothing in the record to demonstrate that the UST put Chanin on notice that it was seeking this greater scope of connections to be disclosed. Accordingly, under the circumstances of this case the Court find it would be unjust to drastically reduce Chanin's fees to punish [*40] it for not providing greater disclosure of its connections to the parties and professionals in this case. The Court will take under advisement the arguments that the UST has presented in connection with the fees Chanin seeks in connection with the legal services it obtained from Wilmer Cutler, and will analyze those services by reference to the standard of reasonableness and benefit to the estate. In sum, the Court grants the UST motion to the extent it seeks a determination that 2014 may require a greater level of disclosure of connections than Chanin provided here, denies the motion to the extent it seeks a "drastic reduction" in Chanin's fee due to a violation of *Rule 2014*, and takes under advisement that portion of the motion that seeks a disallowance of all fees Chanin seeks for Wilmer Cutler legal services.

The Chanin cross-motion for summary judgment seeks an Order (a) overruling the UST's objection to its fee applications and (b) awarding Chanin the full amount of fees it seeks in the third and final fee applications, as modified. The Court grants that aspect of the cross-motion that seeks to have the UST's request for a drastic reduction of Chanin's fee on *Rule 2014* grounds [*41] denied, and defers a determination on the balance of the cross-motion until after it has considered all evidence to be presented in support of the Debtors' outstanding objection to Chanin's fee applications and conducts an independent analysis of the subject fee applications

This constitutes the Court's findings of fact and conclusions of law.

March 11, 2006

Rutland, Vermont

Colleen A. Brown

United States Bankruptcy Judge

ORDER

ON THE U.S. TRUSTEE'S MOTION FOR SUMMARY JUDGMENT AND ON CHANIN'S CROSS-MOTION FOR SUMMARY JUDGMENT

For the reasons set forth in the memorandum of decision of even date, THE COURT FINDS that there are no material facts in dispute and that summary judgment is proper

After due consideration of the record in this case and the arguments presented on summary judgment, the Court HEREBY ORDERS as follows:

1. the Court grants the U.S. Trustee's motion to the extent it seeks a determination that *Rule 2014* may require a greater level of disclosure of connections than Chanin provided here, denies the motion to the extent it seeks a "drastic reduction" in Chanin's fee due to a violation of *Rule 2014*, and takes under advisement that portion [*42] of the motion that seeks a disallowance of all fees Chanin seeks for Wilmer Cutler legal services.

2. the Court grants that aspect of the cross-motion that seeks to have the U.S. Trustee's request for a drastic reduction of Chanin's fee on *Rule 2014* grounds denied, and defers a determination on the balance of the cross-motion until after it has considered all evidence to be presented in support of the Debtors' outstanding objection to Chanin's fee applications and conducts an independent analysis of the subject fee applications.

SO ORDERED.	Colleen A. Brown
March 11, 2006	United States Bankruptcy Judge
Rutland, Vermont	

In re: SAINT VINCENTS CATHOLIC MEDICAL CENTERS OF NEW YORK d/b/a SAINT VINCENT CATHOLIC MEDICAL CENTERS, et al., Debtors.

Chapter 11, Case No. 05 B 14945 (ASH) (Jointly Administered)

UNITED STATES BANKRUPTCY COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

2007 Bankr. LEXIS 3006

August 29, 2007, Decided

NOTICE: NOT FOR PUBLICATION

COUNSEL: [*1] For Saint Vincents Catholic Medical Centers of New York d/b/a Saint Vincent Catholic Medical Centers, Debtor: Andrew M. Troop, Deryck A. Palmer, George A. Davis, John J. Rapisardi, Cadwalader, Wickersham & Taft LLP, New York, NY; Burton S. Weston, Garfunkel, Wild & Travis, P.C., Great Neck, NY; David D. Cleary, LeBoeuf, Lamb, Greene & MacRae LLP, Chicago, IL; Frank A. Oswald, Togut, Segal & Segal LLP, New York, NY; Gary Ravert, James M. Sullivan, Stephen B. Selbst, McDermott Will & Emery, LLP, New York, NY; Marcia L. Goldstein, Richard P. Krasnow, Weil Gotshal & Manges, New York, NY; William P. Smith, McDermott Will & Emery, LLP, Chicago, IL.

For Toniann Decker, Kathleen Sestan, Petitioning Creditors: Anthony Ameduri, Ameduri Galante & Friscia, Staten Island, NY.

For United States Trustee, U.S. Trustee: Alicia M. Leonhard, Richard C. Morrissey, Tracy Hope Davis, Office of the United States, New York, NY.

JUDGES: Adlai S. Hardin, Jr., U.S.B.J.

OPINION BY: Adlai S. Hardin, Jr.

OPINION

ADLAI S. HARDIN, JR.

UNITED STATES BANKRUPTCY JUDGE

DECISION ON OBJECTIONS TO APPLICATION FOR FEES AND EXPENSES

Before the Court is the application for legal fees of $ 2,227,779 and expenses of $ 104,314 of the law firm of McDermott Will & [*2] Emery ("McDermott"). The legal fees and expenses cover the period from July 5, 2005 (the "Petition Date") through September 13, 2005, during which McDermott served as the debtors' bankruptcy counsel. [1] Objections to the application were filed by the Office of the United States Trustee, the Official Committee of Unsecured Creditors and the debtors.

1

Effective September 13, 2005, McDermott was discharged and replaced by Weil Gotshal & Manges as debtors' counsel.

The Court conducted a trial of the objections, and the parties exchanged post-trial briefs, replies and supplemental submissions as requested by the Court. The following constitute the Court's findings of fact and conclusions of law in accordance with *Bankruptcy Rule 7052*.

Jurisdiction

The Court has jurisdiction over this contested matter under *28 U.S.C. ßß 1334(b)* and *157(a)* and the standing order of referral to bankruptcy judges dated July 10, 1984, signed by Acting Chief Judge Robert J. Ward. This is a core proceeding under *28 U.S.C. ß 157(b)(2)(B)*.

Background

The Court's findings of fact are based on the parties' joint statement of "Undisputed and Admissible Facts," [2] the documentary exhibits admitted in evidence including deposition [*3] transcripts, transcripts of Court proceedings, and the testimony of the witnesses. I have included in this Background section only those facts necessary to understand the two objections which I have sustained to the extent set forth in this Decision.

2

Quotations, unless otherwise attributed, are from the statement of "Undisputed and Admissible Facts."

The Debtors

The debtors, collectively referred to as Saint Vincent Catholic Medical Centers ("SVCMC"), own and operate a New York metropolitan area comprehensive health care system. SVCMC serves as the academic medical center of New York Medical College in New York City. As of the Petition Date, SVCMC owned and operated seven hospitals: Saint Vincent's Hospital, Manhattan; Bayley Seton Hospital, Staten Island; Mary Immaculate Hospital, Queens; Saint John's Hospital, Queens; Saint Mary's Hospital, Brooklyn; Saint Vincent's Hospital, Staten Island; and Saint Vincent's Hospital, Westchester. As of the Petition Date, SVCMC also operated numerous debtor and non-debtor affiliates, including four skilled nursing facilities, a hospice, a system-wide home health care agency, and more than sixty off-site ambulatory care centers, providing a broad [*4] array of medical, psychiatric and substance abuse services.

McDermott

McDermott is a large American law firm with more than 1,000 attorneys and offices in nine American cities and five foreign cities. The Court authorized McDermott's retention in the bankruptcy case by final order dated August 8, 2005. McDermott staffed the debtors' cases with attorneys from its Chicago, New York, Washington, DC and Los Angeles offices. William P. Smith ("Smith"), a partner in McDermott's Chicago office, was the partner in charge of the debtors' bankruptcy cases.

The Speltz & Weis, Huron and McDermott pre-petition retentions by SVCMC

On April 13, 2004 SVCMC engaged Speltz & Weis LLC ("SW") to provide management advisory services to SVCMC pursuant to the terms of a management agreement (the "Management Agreement") for a period of one year. On May 5, 2005, the SVCMC Board of Directors (the "Board") voted to renew the Management Agreement through October 31, 2005.

David Speltz ("Speltz") and Timothy Weis ("Weis"), principals of SW, were the senior SW personnel acting under the Management Agreement with SVCMC. On September 17, 2004, the Board appointed Speltz and Weis as the Chief Executive Officer ("CEO") [*5] and Chief Financial Officer ("CFO"), respectively, of SVCMC. They served in these capacities until August 24, 2005.

In September 2004, the same month in which the Board appointed Speltz and Weis as CEO and CFO, respectively, the Board retained McDermott to provide SVCMC with advice regarding a possible debt restructuring. The Board retained McDermott upon the advice and recommendation of Speltz. On September 22, 2004 McDermott presented to the Board various restructuring alternatives, including Chapter 11 protection.

The following month, on October 4, 2004, the Board authorized the retention of Huron Consulting Services LLC ("Huron") as financial advisors to SVCMC upon on the advice and recommendation of McDermott, specifically Smith.

Weis and McDermott were responsible for supervising and directing Huron's work for and billings to SVCMC.

SW's undisclosed retention of Huron as subcontractor

In addition to Huron's disclosed engagement by SVCMC as financial advisor concerning insolvency issues, Huron was also engaged in late 2004 as a subcontractor to SW in connection with management reporting and claims denials. Huron's subcontractor relationship with SW was not disclosed to SVCMC's Board. [*6] As set forth in the Crowley report, discussed below:

> Huron suggested [to SW] that SVCMC needed improvements in the areas of management reporting and claims denials. SWLLC then engaged Huron as a subcontractor to it and sought and obtained from the Chairman [of SVCMC's Board] authorization to add individuals to its management services team to perform such services but did not disclose that such in-

> dividuals were Huron employees or that Huron -- which at that point was already a significant vendor to SVCMC -- had become a subcontractor to SWLLC with respect to these services.

The secret SW/Huron Group acquisition negotiations

Prior to January 2005, the chairman of Huron Consulting Group, Inc. ("Huron Group"), the parent of Huron, approached Speltz to discuss a potential business combination between SW and Huron Group. As a condition of negotiations with Huron Group, Messrs. Speltz and Weis entered into a confidentiality agreement with Huron in January 2005 which prohibited them from disclosing their discussions with Huron Group.

Despite this confidentiality agreement, Smith first learned no later than February 2005 that Speltz and Weis might sell SW and were in discussions with a number of [*7] potential purchasers, including Huron. Smith did not disclose the existence of the negotiations between Speltz and Weis and the Huron Group to his client, the Board of SVCMC.

SW and Huron Group entered into a term sheet for the sale of SW to Huron Group in April 2005. Smith learned from Messrs. Speltz and Weis in an April 26, 2005 telephone conversation that the negotiations regarding Huron Group's potential acquisition of SW were "becoming 'serious.'" Once again, Smith did not disclose the fact of the negotiations to the SVCMC Board.

The parties have stipulated that "[a]fter learning that discussions of a Huron acquisition of SW were becoming serious, Smith commissioned a research memorandum from McDermott attorneys regarding the issues that could arise from such an acquisition in the event of a SVCMC bankruptcy filing." But it would appear that Smith must have given consideration to the "issues that could arise" before April 26, because in the April 26 telephone conversation Weis, Speltz and Smith discussed whether Huron's potential acquisition of SW would have any implications in the event SVCMC filed for bankruptcy and sought to retain SW and Huron on a post-petition basis. On April [*8] 26 Smith advised Speltz and Weis "that the issues were disinterestedness, the Jay Alix Protocol and conflicts." [3]

3

The Jay Alix Protocol is the name given to an agreement between the United States Trustee for the District of Delaware and Jay Alix & Associates in the *Safety-Kleen Corp.* bankruptcy case which concerns the role of financial advisors acting as both financial advisors and crisis managers in the same case. The Protocol recognizes that there is an inherent conflict between an advisor's duty to a debtor and its own business interests where the advisory firm serves as both a financial advisor retained under *Section 327 of the Bankruptcy Code* and as a crisis manager and where the advisory firm's staff serve as officers of the debtor corporation. The Jay Alix Protocol precludes an advisory firm from acting in both capacities in a single bankruptcy case because of this conflict. The Jay Alix Protocol is applicable in the Southern District of New York, and as noted in the text, Smith advised Speltz and Weis in the April 26 telephone conversation that the Jay Alix Protocol would be an issue in any applications to retain both SW and Huron in the bankruptcy case.

Elizabeth St. Clair [*9] ("St. Clair") was SVCMC's Chief Legal Officer. In mid-April St. Clair approached Speltz to discuss a rumor that SW was to be acquired by Huron Group. Speltz falsely denied the rumor and did not disclose the ongoing negotiations between SW and Huron.

On May 5, 2005, the Huron Group, SW, Speltz and Weis entered into an agreement for Huron Group to acquire SW (the "Acquisition Agreement"). The acquisition of SW by Huron Group closed on May 9, 2005, and Speltz and Weis personally entered into employment contracts with Huron.

Prior to May 6, 2005, neither Speltz nor Weis had disclosed to the SVCMC Board their discussions with Huron Group. Neither Smith nor anyone else at McDermott disclosed the existence of the SW/Huron negotiations before May 6, 2005. Speltz finally disclosed Huron's acquisition of SW to Richard Boyle ("Boyle"), Chairman of the SVCMC Board, on or shortly after May 6, 2005, and Speltz disclosed the acquisition to St. Clair one or two days later.

Upon learning of Huron Group's acquisition of SW, and on the initiative St. Clair, the Board retained as special counsel Leo Crowley ("Crowley") of Pillsbury Winthrop Shaw Pittman LLP to investigate the Huron Group's acquisition of [*10] SW. Crowley had been with Pillsbury Winthrop Shaw Pittman LLP for twenty-six years and was the leader of the firm's insolvency and restructuring practice. Crowley was advised by St. Clair and other members of the Executive Committee to treat the investigation as a confidential matter, which would be subject to "attorney-client privilege."

On July 6, 2005 Crowley sent a draft report dated June 29, 2005 to SVCMC's Board Chairman Richard Boyle and Edward Lahey, another member of the Board. Crowley's final report, labeled **"DRAFT,"** was dated and delivered to the SVCMC Board Chairman on July 18, 2005. The discussion below is based on the July 18 report.

Breaches of fiduciary duty and conflicts arising from the SW/Huron acquisition

Under the Acquisition Agreement SW was not merged or dissolved. It continued to exist as a subsidiary of Huron Group. Speltz and Weis, as former principals and owners of SW, received two types of compensation or "earn-outs." One was based on the post-acquisition revenues of SW. The other earn-out provision (the "percentage of SVCMC earnings" provision) was based on revenues derived by Huron from SW clients, specifically SVCMC. Under this percentage of SVCMC earnings [*11] provision, Speltz and Weis would personally receive payments from Huron based on a percentage of what SVCMC would pay to Huron for the insolvency services for which Huron had been previously engaged and which Speltz and Weis were responsible for supervising and controlling on behalf of SVCMC. As a consequence of the acquisition, Speltz and Weis became employees of Huron under written employment contracts.

The negotiations between Speltz and Weis and Huron Group and the contractual relationships resulting from Huron Group's acquisition of SW gave rise to serious breaches of the Management Agreement between SW and SVCMC, breaches of fiduciary duty and conflicts of interest on the part of Speltz and Weis. These breaches and conflicts are self-evident, but they are aptly summarized in the Crowley report, from which I shall quote:

> [T]he present arrangement [referring to the SW/Huron Group Acquisition Agreement and the Speltz and Weis employment contracts], and the manner in which it was entered into, breached several aspects of the management agreement between SWLLC and SVCMC.
>
> . . .
>
> 1. By signing the confidentiality agreements with Huron in January 2005, their outside activities in negotiating [*12] with Huron interfered with the performance of their duties [to] SVCMC because Speltz and Weis undertook contractual obligations to Huron that were inconsistent with their duty of disclosure to SVCMC. ...
>
> 2. Speltz's and Weis' duties to SVCMC include supervising the work of Huron as SVCMS's [sic] financial advisor, a matter of importance to SVCMC. They have effectively rendered themselves unable to fulfill that responsibility because they (now being both SVCMC officers and Huron employees) are conflicted from doing so. The complex arrangements among SWLLC, Speltz and Weis personally and Huron have injected complications into the ability of SVCMC to engage Huron as an estate professional under *section 327 of the Bankruptcy Code*. At a minimum all of these matters would have to be disclosed to the US Trustee, and to the bankruptcy court in a public filing, and subject to challenge and criticism by creditors and others. ...
>
> 3. SWLLC's responsibilities under the management agreement cannot be assigned or delegated, without the prior approval of the SVCMC board (see clause 11j of the management agreement). However, because Speltz and Weis and apparently Fan-

> ning are no longer employees of SWLLC [*13] but instead are employees of Huron, they have in effect delegated responsibility to Huron without the Board's permission. ...

Regarding conflicts of interest, the Crowley report states:

> SVCMC's conflict of interest policy requires that "covered persons" (which includes Speltz and Weis because they are officers) must fully disclose any "potential or actual conflict of interest," and "must refrain from participating in any consideration of any transaction with a vendor until the matter has been reviewed and resolved."

This provision of the conflict of interest policy was obviously violated. The Crowley report notes that Huron was a major vendor of SVCMC as its financial advisor on insolvency matters, that Speltz and Weis negotiated with Huron from January 2005 through the date of their written agreement on May 6, 2005, and that "Speltz and Weis did not disclose their proposed transaction with Huron until Friday, May 6<th>." The report notes: "[a]lso during the first part of 2005, SWLLC engaged Huron as a subcontractor to perform services under the umbrella of the existing SWLLC management agreement," and that Speltz and Weis "did not disclose . . . that Huron . . . had become a subcontractor [*14] to SWLLC. . . ." [4] The report notes also that "there is no exception in the conflict of interest policy that permitted Speltz & Weis to voluntarily place themselves in a position where they apparently had conflicting contractual obligations to Huron and conflicting fiduciary obligations to SVCMC." The Crowley report concludes as follows:

> 1. They [Speltz and Weis] failed to disclose the potential conflict of interest created by their discussions with Huron. Because Huron was a significant and important vendor to SVCMC which they were personally responsible for supervising and because of the size of their personal financial interests, this failure was serious. . . . Huron, which was a relative newcomer to SVCMC having been engaged only in the fall of 2004, was seemingly locking in its position by procuring the favor of SVCMC's CEO and CFO. ...
>
> 2. They subcontracted Huron to SWLLC at a time when Huron was already a vendor and presumably marked up Huron's rates (SWLLC bought services from Huron wholesale and resold them at a higher price to SVCMC). ... [T]he conflict of interest policy prohibited Speltz and Weis from having an undisclosed interest in a vendor as to which they were in a position [*15] to influence any substantive business decision between SVCMC and the vendor. An "interest" for this purpose includes a contractual relationship, and Speltz and Weis had management responsibility for Huron's work for SVCMC, and were responsible for reviewing and approving Huron's bills.
>
> 3. They entered into a contract with an "earn-out" that pays them a percentage of what SVCMC pays Huron. While the preexisting management agreement gave SWLLC some financial interest in services rendered by their personnel, the Huron insolvency engagement is one that is not within SWLLC's line of business. Moreover, since Huron was willing to in effect cede to Speltz and Weis a portion of the revenues from its engagement with SVCMC, circumstances have the appearance of Speltz and Weis negotiating a discount from Huron for services rendered to SVCMC, and then appropriating for themselves the value of that discount. ...

4

The secret subcontractor relationship under which SW utilized Huron employees to perform services for SVCMC and charged SVCMC a mark-up on the Huron employees' costs was a particularly repugnant breach of fiduciary duty on the part of Speltz and Weis. Board Chairman Richard Boyle testified [*16] that, upon discovery of this subcontractor relationship, the Board required SW to reimburse SVCMC $ 183,000

> on account of the mark-up. (Tr. Oct. 24, 2006 p. 93)

Finally, the Crowley report noted that Speltz and Weis violated their fiduciary duty under New York law.

> As officers of a New York not for profit corporation Speltz and Weis individually had inherent fiduciary duties to SVCMC, which included, among other things, complying with the conflict of interest policy, and not acquiring interests adverse to the interests of SVCMC unless such interests had been approved by the board after disclosure of all relevant facts.

Bankruptcy retention of SW and Huron

One of the two critical issues in these fee objections concerns McDermott's handling of SVCMC's prolonged, divisive and ultimately futile attempt to seek Bankruptcy Court approval of the proposed professional retentions of SW and Huron. The process commenced with the filing of retention applications with the "first day orders" on July 5, 2005, the petition date, and was marked by ever-increasing contention, animosity, and most devastating in a Chapter 11 case, lack of trust between the debtors and their counsel, McDermott, and the Creditors' [*17] Committee and the United States Trustee's office. The process culminated disastrously with the forced resignations of Speltz and Weis as CEO and CFO of SVCMC on August 24, 2005 and, three weeks later, the termination of McDermott as debtors' counsel on September 13, 2005.

SW and Huron each wanted to be approved for retention by the Bankruptcy Court for public relations purposes. McDermott determined initially to seek Court approval of the SW Management Agreement under *Bankruptcy Code 363* and of Huron's retention under *Section 327*. McDermott reported to Speltz and Weiss, who were obviously conflicted, issues concerning approval of the SW Management Agreement and the retention of Huron and possible alternative strategies. But McDermott apparently did not report these issues adequately to the SVCMC Board. Smith was aware that Crowley was investigating the propriety of the Huron Group acquisition of SW (Smith was interviewed by Crowley on June 23, 2005). McDermott attorneys responsible for the SVCMC bankruptcy case had studied the Acquisition Agreement and the Speltz and Weis employment contracts with Huron and were therefore aware of the multiple conflicts and breaches of fiduciary duty [*18] on the part of Speltz and Weis. Smith instructed another McDermott attorney to include disclosures about the Huron Group's acquisition of SW, the Speltz and Weis employment contracts and the earn-out arrangements between SW and the Huron Group in the retention motions to be filed with the Court.

In fact, McDermott never made full and candid disclosure respecting the Huron acquisition of SW and the consequent conflicts and breaches of fiduciary duty by Speltz and Weis.

On July 5, 2005 McDermott filed separate motions (the "July 5 Motions") to retain Huron under *Section 327 of the Bankruptcy Code* and to approve the SW Management Agreement under *Section 363* of the Code. McDermott was responsible for determining the disclosure to be made in the July 5 Motions and thereafter. Although the Motions did disclose the bare fact of the Huron Group acquisition of SW, the July 5 Motions did not disclose any details of the acquisition, the Speltz and Weis Employment Agreements or the earn-out provisions. Nor was there any disclosure of the conflicts or breaches of fiduciary duty resulting from the acquisition and related agreements or their implications for the Huron and SW retentions, which were [*19] the object of the July 5 Motions. Indeed, the July 5 Motions represented that SW was a "materially disinterested person," despite the fact that Speltz and Weis were grossly conflicted as a consequence of the Huron Group acquisition of SW and the percentage of SVCMC earnings provision.

Smith acknowledged in testimony that the July 5 Motions were careless, incomplete and inappropriate. Both Motions were withdrawn shortly after July 5.

On July 13, 2005 McDermott filed an amended motion to approve the SW Management Agreement. The disclosures in the July 13 motion were also woefully deficient, and two days later McDermott filed a notice of adjournment without date of the July 13 motion. Between July 5 and August 24, 2005, McDermott circulated numerous drafts of the retention motions for SW and Huron among parties including the U.S. Trustee's office, the Creditors' Committee, the debtors' senior management, Huron's counsel, SW's counsel and Crowley (although Crowley had no responsibility with respect to the retentions of Huron and SW or any other bankruptcy matters, which were solely the responsibility of McDermott).

It is unnecessary to this ruling to present a detailed recapitulation of the [*20] evidence concerning the increasingly contentious intercourse among the parties between July 5 and August 24 when the Board finally called for the resignations of Speltz and Weis. Suffice it to say that, as the weeks passed after the soon-aborted July 5 Motions and the adjourned-without-date July 13 motion, McDermott continued to press for the SW and

Huron retentions despite the increasing resistance of both the Creditors' Committee and the U.S. Trustee. As the parties have stipulated:

> Smith understood, based on a July 21, 2005 conversation with Martin Bunin, acting as counsel to the Committee, that the Committee objected to the Debtors' attempt to approve the Management Agreement or retain Huron but gave no reasons for the Committee's opposition other than "Speltz & Weis were really bad guys and they had to go;" they were "paid a lot of money"; and "their turnaround plan didn't work." Smith understood, based on Bunin's comments, that "there were no circumstances under which [the Committee] would agree to the retention of Speltz & Weis."

Nevertheless, McDermott continued to press for Court approval of the SW Management Agreement and *Section 327* retention of Huron, until August 1. The [*21] parties have stipulated that "McDermott withdrew the Huron application on August 1, 2005," but problems with the SW approval continued and "on August 12, 2005 the UST informed McDermott by letter that UST's 'concerns have not been resolved by the amendments to' the July 28 draft motion to approve the [SW] Management Agreement."

By early August the Creditors' Committee and the U.S. Trustee had grave doubts about the competence and efficacy of Speltz and Weis as the senior management of SVCMC. Both the Committee and the Trustee had lost confidence in Speltz and Weis. McDermott, the U.S. Trustee and the Creditors' Committee counsel met on August 19, 2005. At the August 19 meeting, the U.S. Trustee stated that she would not consent to SW's retention, and the U.S. Trustee and the Committee proposed the appointment of a "Chief Restructuring Officer" ("CRO").

The U.S. Trustee's CRO proposal obviously had very serious implications for SVCMC and its management. Responding to this impetus, the debtors' Executive Committee of the Board convened a "special" meeting on August 24, 2005 to discuss the August 19 meeting and its implications. At the August 24 meeting Smith relayed to the Executive Committee [*22] the concerns articulated by the Creditors' Committee and the U.S. Trustee regarding Speltz and Weis. After thorough and comprehensive discussion at the August 24 meeting, it was decided that the Executive Committee would ask Speltz and Weis to resign from their positions as CEO and CFO, respectively, and the Executive Committee appointed Richard Boyle as interim President and CEO and Thomas Allison as interim CFO of SVCMC.

The closure of St. Mary's Hospital

The other objection to McDermott's fee application which I have found meritorious relates to the firm's handling of the closure of St. Mary's Hospital. Closure of this Hospital was from the beginning a high priority for SVCMC because operation of the Hospital was costing SVCMC an average loss which the debtors put at $ 78,000 a day. [5] The background facts relating to this objection are concisely summarized in the parties' agreed statement of Undisputed and Admissible Facts, as follows:

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> *See* objecting parties' Post-Trial Statement of Economic Consequences page 2 at footnote 1. In its August 18 motion seeking Bankruptcy Court approval to close St. Mary's Hospital, McDermott referred in paragraph 47 to "[t]he continued expense of more [*23] than $ 100,000 per day to fund the losses of St. Mary's Hospital operations. . . ." In the Debtors' Omnibus Response to Objections to the SVCMC motion to close St. Mary's Hospital dated September 2, 2005, McDermott asserted that "St. Mary's Hospital is currently losing more than $ 500,000 per week," which would average approximately $ 71,428 per day.

D. CLOSURE OF SAINT MARY'S HOSPITAL

> 105. On June 1, 2005, prior to the Petition Date, the Debtors' Board of Directors (the "Board") resolved to close St. Mary's Hospital.
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> 106. Smith attended the June 1, 2005 Board meeting.
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> 107. On June 1, 2005, the Board instructed management and counsel, including McDermott, to take the necessary and appropriate action for the closure of St. Mary's Hospital.

108. McDermott knew that the Debtors wanted to close St. Mary's as promptly as applicable regulatory approvals could be obtained.

109. The closure of St. Mary's was subject to the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure.

110. McDermott was primarily responsible for obtaining Court approval of the closure of St. Mary's, while the Debtors' internal management, including Bernadette Kingham-Bez and Elizabeth St. Clair, Esq., was primarily [*24] responsible for the steps required to obtain canonical and regulatory approval of the closure.

111. In late June 2005, prior to the Petition Date, the Debtors had already obtained canonical authority to close St. Mary's.

112. The Debtors' management, not McDermott, had primary responsibility for obtaining DoH [New York Department of Health] approval to close St. Mary's Hospital.

113. In June 2005, prior to the Petition Date, the Debtors made the application to the DoH to close St. Mary's Hospital.

114. McDermott did not review, and was not asked by SVGMC to review, the application to close St. Mary's that was made to the DoH prior its filing.

115. At a June 17, 2005 meeting of the Executive Committee of the Board, the Executive Committee discussed the progress of the closure of St. Mary's Hospital setting as the target date for closure September 1, 2005.

116. Smith attended the June 17 meeting of the Executive Committee at which the Executive Committee set September 1, 2005, as the target date for the closure of St. Mary's Hospital.

117. In connection with the St. Mary's Hospital closure, McDermott provided certain services, including: (I) representing the Debtors in state court litigation [*25] (the "State Court Litigation") regarding the approval by the New York Department of Health of the closure plan; (ii) commencing an action in the Debtors' chapter 11 cases seeking, among other things, a declaration that the plaintiff in the State Court Litigation had violated the automatic stay; (iii) preparing and filing a motion, dated August 18, 2005, seeking authority to close St. Mary's Hospital (the "St. Mary's Motion"): (iv) responding to objections filed in opposition to the St. Mary's Motion; (v) appearing at a hearing on August 23, 2005, on issues relating to the closure of St. Mary's Hospital; and (vii) [sic] appearing at a hearing on the St. Mary's Motion on September 7, 2005.

118. Certain members of the St. Mary's community and employees contested the closure.

119. McDermott caused a series of motions to be filed on behalf of Debtors on the Petition Date (the "First Day Motions").

120. McDermott did not file a motion seeking permission to close St. Mary's Hospital with the First Day Motions.

121. McDermott disclosed the Debtors' intention to close St. Mary's Hospital on the Petition Date in an affidavit (i.e., Weis's affidavit under Local Bankruptcy *Rule 1007-1*) filed with [*26] the First Day Motions and in colloquy with the Court.

122. On July 22, 2005, the Debtors issued notices of the St. Mary's closure to employees under the WARN ACT.

123. Between the Petition Date and July 22, 2005, McDermott took no steps to seek Bankruptcy Court permission to close St. Mary's Hospital.

124. In the state court litigation, where the Debtors were not named as parties, Harriett [sic] McCloud, a former patient of St. Mary's Hospital, obtained an ex-parte temporary restraining order in Kings County Supreme Court on July 22, 2005, restraining the DoH from approving a closure plan for St. Mary's Hospital (the "State Court Litigation").

125. On July 29, 2005, McDermott filed a complaint with the Bankruptcy Court, seeking a preliminary and permanent injunction to enjoin Ms. McCloud

from prosecuting the State Court Litigation.

126. On August 4, 2005, [McDermott attorney] Selbst appeared on behalf of the Debtors at a hearing in the Bankruptcy Court on the Debtors' application for a preliminary and permanent injunction.

127. After the August 4, 2005 hearing, Selbst and St. Clair both "felt that someone else had to handle the [August 5] hearing and neither of them wanted to go back into [*27] Court the next day."

128. McDermott first began work on a motion seeking permission from the Bankruptcy Court to close St. Mary's Hospital (the "St. Mary's Motion") no earlier than August 5, 2005.

129. McDermott filed the St. Mary's Motion on August 18, 2005.

130. By August 18, 2005, the Debtors were close to obtaining, but had not obtained, DoH approval to close St. Mary's Hospital.

131. The DoH approved the closure of St. Mary's Hospital on August 31, 2005.

132. Objections to the closure of St. Mary's Hospital were filed by the following objectors: (I) Brooklyn Safety Net, LLC ("BSN") on August 30, 2005; (ii) Harriet M. McCloud on August 31, 2005; (iii) the Medical Staff (Physicians) Committee of St. Mary's, Mary Immaculate, and St. John's Hospitals on August 31, 2005; and (iv) the Bedford Stuyvesant Family Health Center, Inc. and Brownsville Multi Service Family Health Center on September 7, 2005.

133. BSN purported to be an entity formed by certain employees to purchase St. Mary's to avoid its closure.

134. The UST took no position with respect to the Debtors' efforts to close St. Mary's Hospital.

135. McDermott prepared and filed on September 2, 2005, the Debtors' omnibus reply to the [*28] objections to the St. Mary's Motion.

136. As part of the Debtors' reply, McDermott filed no affidavits or declarations in response to any of the objectors' objections.

137. The Committee filed a short response in support of McDermott's motion to close St. Mary's Hospital on September 2, 2005.

138. The Court held a hearing on the St. Mary's Motion on September 7, 2005.

139. Selbst represented the Debtors at the September 7 hearing.

140. McDermott offered no testimony from any witnesses at the September 7, 2005 hearing.

141. At the September 7, 2005 hearing, the Committee's counsel made statements supporting the closure of St. Mary's Hospital.

142. The Court did not grant the St. Mary's Closure Motion on September 7, 2005, and the hearing was adjourned.

143. On September 19, 2005, Weil, on behalf of the Debtors, filed the declarations of: Linda Brady, M.D., Kingsbrook HealthCare System LLC's president; Thomas M. Barry, Managing Director of Cain Brothers & Company, LLC (as supplemented on September 19, 2005); Dawn Gideon, the Debtors' then-Interim Chief Restructuring Officer; and Sister Jane Iannucelli, a member of the Board, in support of the St. Mary's Motion.

144. The Court resumed the hearing [*29] on the St. Mary's Motion on September 20, 2005.

145. Weil appeared on behalf of the Debtors at the September 20, 2005 hearing.

146. At the September 20, 2005 hearing, Weil presented testimony from Sister Jane Iannucelli, vice chairman of the Board.

147. The Court approved the closure of St. Mary's Hospital at the September 20, 2005 hearing.

Termination of McDermott as debtors' counsel

By the close of business on September 7, 2005, some progress had been made in the SVCMC reorganization proceedings. But two important objectives had hot been accomplished, the Huron retention and closure of St. Mary's Hospital.

Professional retentions are generally presented to the Court as "first day orders" in major Chapter 11 cases. But after more than two months Huron had not been retained under *Section 327* despite the fact that scores of its employees were devoting their full time to the debtors' affairs in essential positions. As a quite predictable consequence of the Huron Group acquisition of SW and the insistence of Speltz and Weis that both Huron and SW be retained for public relations reasons, the Huron retention became intractably mired in the attempt, relentlessly pressed by the SVCMC management [*30] (*i.e.,* Speltz and Weis) and McDermott, both to retain Huron and to approve the SW Management Agreement. This attempt was doomed from the outset because of the Huron Group/SW conflict prohibited by the Jay Alix Protocol, and the conflicts of interest and breaches of fiduciary duty on the part of Speltz and Weis. But the exercise in futility did not end until the SVCMC Board fired Speltz and Weis on August 24.

The closing of St. Mary's Hospital was critical triage to staunch the ongoing hemorrhage averaging $ 71,000 to $ 100,000 every day. Before the bankruptcy filing, the Board charged its professionals to accomplish this objective by September 1. All approvals necessary to achieve closing by September 1 had been obtained, except one -- Court approval. Indeed, the Court did not have a sufficient record to approve the closing over the vociferous objections of various local groups at the hearing on September 7.

Both the Huron/SW retentions and Court authorization to close St. Mary's Hospital by the September 1 deadline set by the Board were the responsibility of McDermott. The disastrous out-come of the Huron/SW approval process undermined the debtors' and McDermott's credibility and relationship [*31] with the Creditors' Committee and the U.S. Trustee's office. The belated and unsuccessful proceedings relating to St. Mary's Hospital undermined the debtors' and McDermott's credibility with the Court as well as the debtors and the Creditors' Committee.

Following the September 7 hearing on St. Mary's, the Board made the decision to discharge McDermott and retain Weil, Gotshal & Manges as debtors' counsel. Boyle, then Chairman of the Board and Interim CEO of SVCMC, made the decision. Boyle made this statement in his trial declaration: "It became readily apparent to me that the restructuring of SVCMC was in a quagmire, and that the bankruptcy process could not go forward with MWE continuing as counsel to SVCMC, given the frayed relationships between MWE, on the one hand, and the U.S. Trustee and Committee, on the other. ... [B]ecause the Board had lost confidence in MWE's ability to guide SVCMC through the bankruptcy process, we needed to replace MWE as counsel to the Debtors." Boyle also gave this testimony as to the reasons for the change in counsel:

> it became increasingly obvious to me that the debtor and myself in this position was facing a significant credibility crisis with the [UST] [*32] and people on the [UST]'s staff, certain members of the creditors committee and certain of the creditors committee financial advisors and representatives. They were being increasingly demanding of the immediate appointment of a chief restructuring officer and demanding among other things the formation of a committee that would have been tantamount to the board giving up its responsibilities and threatening to appoint a receiver. It was clear to me as I went through these different deliberations that we could not replace the [UST], we certainly didn't have the power to replace the judge, there was no way we had any influence to replace the chair of the creditors committee or any of the advisors to the creditor [sic] committee. I thought long and hard over the weekend just prior to around the 10<th> of September, what we could do to remedy this quagmire we were in in terms of having all this lack of credibility. And I felt the only reasonable thing to do from a business point of view was to have a change in counsel.

Smith acknowledged in his testimony that if McDermott had not been terminated as counsel the firm probably would have resigned because the firm's effectiveness was at an end. [*33] Smith said: "It was apparent that the trustee and the committee were not willing to work with McDermott as counsel at St. Vincent's."

Discussion

I. The Bankruptcy Code and retrospective review

Compensation of professionals is covered in *Section 330 of the Bankruptcy Code*. *Section 330*, as it existed prior to October 17, 2005, provided as follows, in pertinent part:

***11 USC ß 330*. Compensation of officers**

(a) (1) After notice to the parties in interest and the United States Trustee and a hearing, and subject to sections 326, 328, and 329, the court may award to a trustee, an examiner, or a professional person employed under *section 327* or *1103* --

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

(B) reimbursement for actual, necessary expenses.

(2) The court may, on its own motion or on the motion of the United States Trustee, the United States Trustee for the District or Region, the trustee for the estate, or any other party in interest, award compensation that is less than the amount of compensation that is requested.

(3) In determining the amount of [*34] reasonable compensation to be awarded, the court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including --

(A) the time spent on such services;

(B) the rates charged for such services;

(C) whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title;

(D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed; and

(E) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.

(4) (A) Except as provided in subparagraph (b), the court shall not allow compensation for --

(I) unnecessary duplication of services; or

(ii) services that were not --

(I) reasonably likely to benefit the debtors' estate; or

(II) necessary to the administration of the case.

This statute requires the Court to make a retrospective review of the services rendered by counsel to determine whether the services were "necessary . . . or beneficial [*35] at the time at which the service was rendered" and whether the services "were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or tax addressed." The Court must determine long after the fact whether the services were or were not "reasonably likely to benefit the debtor's estate" or "necessary to the administration of the case."

It is an inevitable fact of life that events and conduct are judged after the fact, with the proverbial benefit of 20-20 hindsight. What may have been difficult for some to assess at the time may appear self-evident to others in hindsight. But experienced counsel in major Chapter 11 cases are paid to investigate the facts, to know the applicable principles of law, practice and ethics, to act timely to accomplish their clients' objectives, and to guide their clients with a firm hand to the course of action which is most beneficial to the debtor's estate. Counsel charge and are paid high compensation in the fair expectation that their foresight and judgment will assess today's facts as the facts will be perceived and judged tomorrow under the searching gaze of 20-20 hindsight. McDermott [*36] failed in this, at great cost to the client.

II. Retention of Huron and SW

It is not inappropriate to be reminded that McDermott was retained by SVCMC in September 2004 on the recommendation of Speltz, and that Huron was retained by SVCMC in October 2004 on the recommendation of McDermott.

McDermott manifested an insensitivity to the interests of its client, SVCMC, and the pitfalls inherent in the Huron Group/SW negotiations and acquisition from the outset. Smith learned not later than February 2005 that Speltz and Weis were negotiating with Huron Group concerning a possible acquisition. He learned in April 2005 that the negotiations with Huron Group were nearing finality. Speltz and Weis, as the senior executives of SVCMC, were responsible for oversight of the activities of and billings by Huron. The secret negotiations obviously gave rise to a clear and present conflict of interest and a breach of fiduciary duty on the part of Messrs. Speltz and Weis. As counsel to SVCMC and ultimately its Board of Directors (not Speltz and Weis), Smith should have disclosed his knowledge of the Huron Group/SW negotiations to Boyle, as Chairman of the Board, and advised Boyle of the potential issues [*37] which he advised the conflicted Messrs. Speltz and Weis, namely, "disinterestedness, the Jay Alix Protocol and conflicts." Smith's reason for not disclosing his knowledge to the Board -- that Speltz told him he had already informed Boyle (denied by Speltz and concededly not true) -- is no reason at all. If Speltz, who is not a lawyer and was conflicted, had discussed the negotiations with Boyle, what possible objection could there be to Smith's discussing the topic with Boyle in order to give Boyle legal advice concerning the serious pitfalls from SVCMC's perspective.

As noted above, "SW and Huron each wanted to be approved for retention by the Bankruptcy Court for public relation purposes," and this was the objective which the SVCMC senior management (*i.e.,* Messrs. Speltz and Weis) instructed McDermott to pursue. Competent counsel, acting in the interests of the client, SVCMC, as distinguished from the interests of senior management Speltz and Weis and their new employer Huron, should have recognized from the outset that the dual retention of Huron under *Section 327* and approval of the SW Management Agreement under *Section 363* would be a practical impossibility if full disclosure were [*38] made concerning all relevant terms of the Huron Group acquisition of SW, the employment agreements between Huron Group and Speltz and Weis, the earn-out provisions (especially the percentage of SVCMC earnings provision) and the breaches of fiduciary duty and conflicts of interest on the part of Speltz and Weis.

The Jay Alix Protocol precluded the dual retention of Huron and SW. The Jay Alix Protocol is posted on the website of the Office of the U.S. Trustee for the Southern District of New York at http://www.usdoi.gov/ust/r02/manhattan/chapter11.htm and is applicable in the Southern District of New York. Smith was aware of the Jay Alix Protocol prior to July 5, 2005, and he advised Speltz and Weis in the April 26 telephone conversation concerning the prospective consequences of the Huron Group acquisition of SW on the dual retention of Huron and SW "that the issues were disinterestedness, the Jay Alix Protocol and conflicts." In pertinent part the Jay Alix Protocol states:

> JA&A and its affiliates [footnote omitted] will not act in more than one of the following capacities in any single bankruptcy case: (I) crisis manager retained under *Sec. 363*, (ii) financial advisor retained under *Sec. 327*, [*39] (iii) claims agent/claims administrator appointed pursuant to *28 U.S.C. ß 156(c)* and any applicable local rules or (iv) investor/acquirer; and upon confirmation of a Plan may only continue to serve in a similar capacity. Further, once JA&A or one of its affiliates is retained under one of the foregoing categories it may not switch to a different retention capacity in the same case.
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> * * *
>
> A. Pursuant to the "one hat" policy as stated above, after accepting an engagement in one capacity, JA&A and affiliates shall not accept another engagement for the same or affiliated debtors in another capacity.

McDermott was aware within a day after the July 5 Motions were filed that the U.S. Trustee's office would oppose the Huron retention based on the Jay Alix Protocol. Thus, Crowley's email dated July 6, 2005 to Richard Boyle stated: "Another point which I learned from Bill Smith, which may have already reached your attention, is that the US Trustee would not approve of Huron as an estate professional so Bill is trying an alternative approach which would have Huron function as in effect a sub-contractor to Speltz & Weis LLC." [6] The conflict of interest between Huron and SW resulting from the acquisition [*40] of SW by Huron Group was self-evident and lay at the core of the Jay Alix Protocol. Smith knew of the Jay Alix Protocol, as he advised Speltz and Weis on April 26, and the Protocol appears on the website of the Office of the U.S. Trustee for the Southern District of New York. Smith's subsequent disclaimer that he thought the Jay Alix Protocol might not be applied in the Southern District because of other examples where the Protocol was not applied is unsupported and, in any event, was belied from the outset by the U.S. Trustee's firm position, as reflected in the July 6 email reporting that "the U.S. Trustee would not approve of Huron as an estate professional."

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> Putting aside the questionable viability of this suggested palliative to avoid *Section 327* disinterestedness scrutiny, it should be recalled that, unbeknownst to and unapproved by the SVCMC Board, Huron already was a subcontractor to SW by means of which SW was charging SVCMC a markup on the cost of Huron employees.

The Huron/SW conflict was immeasurably compounded by the personal conflicts and fiduciary breaches of Messrs. Speltz and Weis. Smith's advice to Speltz and Weis in the April 26 telephone conversation that the prospective [*41] Huron Group acquisition would raise issues of "disinterestedness" and "conflicts" was prescient. What Smith did not know on April 26, but what the McDermott lawyers certainly did know or should have known after reviewing the Acquisition and Employment Agreements and interrogating Speltz and Weis, was that the problems of lack of disinterestedness, conflicts of interest and breaches of fiduciary duty by Speltz and Weis were of such gravity that those matters (and, of course, the Crowley report itself) *could not be disclosed* without virtually annihilating any likelihood of approval of the Speltz and Weis retention and undermining public confidence in the management of SVCMC.

The seriousness of the Speltz and Weis conflicts and breaches and the need to prevent disclosure is clearly reflected in the trial evidence. For example, in a June 23, 2005 email to his associate Cleary concerning the SW and Huron retentions, Smith said:

> 1. Both Speltz and Weis have personal employment contracts with Huron; and
>
> 2. Both Speltz and Weis have earnout arrangements predicated on future business to Huron from legacy S&W clients and insolvency business referred to Huron based on S&W engagements. Crowley (who [*42] is a bankruptcy lawyer) suggested that at a minimum these were disclosure items for any retention applications involving Huron or S&W. Better have whomever is doing these (Augsperger?) read, analyze, and tell us if we're saying what we need to say and doing it the way we should. Also, be aware that my conversation with Crowley was privileged, his report when rendered may never be public, and he is trying to find a way from a corporate/NFP perspective to make this work, as should we, but his solution may involve some board member taking over supervision of Huron's engagement, since it certainly smells like David and Tim have a personal financial interest in pumping up the Huron revenues.

Smith's June 23 email clearly focused on the "earnout arrangements predicated on future business to Huron from legacy S&W clients and insolvency business referred to Huron based on S&W engagements" and observed, correctly, that "it certainly smells like David [Speltz] and Tim [Weis] have a personal financial interest in pumping up the Huron revenues." Smith's June 23 email also reflects Smith's comprehension of the seriousness of the Speltz and Weis conflicts and breaches of fiduciary duty and the consequent [*43] need to curtail disclosure of these matters. He warns Cleary to "be aware that my conversation with Crowley was privileged, his report when rendered may never be public, and he is trying to find a way from a corporate/NFP [not for profit] perspective to make this work, *as should we*" (emphasis supplied). Concerning his June 23, 2005 interview with Crowley, Smith said in his direct testimony trial affidavit (P 57): "I also told Cleary that Crowley expressed concern about the reactions of external constituencies, such as Elliott Spitzer, examiners, the Committee, and disgruntled employees, if the Debtors' cases became a meltdown."

As noted above, the disclosure in the July 5 Motions was grossly and concededly inadequate, and none of McDermott's subsequent draft retention motions contained complete or appropriate disclosures concerning the terms of the Huron Group/SW acquisition and the Speltz and Weis conflicts and fiduciary breaches.

Smith well understood McDermott's obligation as debtors' counsel to make disclosure of these matters, but McDermott did not do so. In his direct testimony by affidavit, Smith stated "I told St. Clair that if she gave me a copy of the Crowley report, I would [*44] have to give it to the UST and the Committee." Speltz, Weis and even Crowley were aware of and concerned about the impact of complete disclosure. As noted in McDermott's post-trial memorandum (P 50): "But Weis complained about Smith's complete disclosure (*see* Oct. 23, 2006 Tr., 283, 17-21), and even Crowley echoed Weis' concerns about too much disclosure. *See* July 27, 2005 email from Crowley to Smith . . . ('[Speltz] and [Weis] have a legitimate concern (which affects not just them but also the Hospital) about opening the door and the possibility of the Committee and the US Trustee rushing in.')." The "possibility of the Committee and the US Trustee rushing in" -- *i.e.,* seeking to replace management with a CRO or Chapter 11 trustee -- was very real as it turned out, even without full disclosure.

Complete and timely disclosure of all relevant and material information and documents lies at the heart of the bankruptcy process. This is particularly so in a Chapter 11 case, where the Creditors' Committee and the U.S. Trustee's office, each with fiduciary duties of their own, must have confidence and trust in the debtor and its professionals. *See, In re Mercury, 280 B.R. 55-56 (Bankr. S.D.N.Y. 2002)* [*45] *aff'd and reinstated, Fellows & Hymowitz, P.C. v. Mercury (In re Mercury), 122 Fed. Appx. 528, 2004 U.S. App. LEXIS 25481 (2d Cir. 2004)*. For disclosure requriements in other contexts, *see also, Momentum Mfg. Corp. v. Employee Creditors Committee (In re Momentum Mfg. Corp.), 25 F.3d 1132, 1136 (2d Cir. 1994)* (in the context of Chapter 11, "'Full and fair' disclosure is required during the entire reorganization process; it begins 'on day one, with the filing of the Chapter 11 petition.'" (quoting *In re v. Savino Oil & Heating Co., 99 B.R. 518, 526 (Bankr. E.D.N.Y. 1989))*; *see also, Texaco Inc., v. Bd. of Commissioners for the LaFourche Basin Levee District, et al. (In re Texaco Inc.), 254 B.R. 536, 561 (Bankr. S.D.N.Y. 2000)* (Chapter 11). "The courts have uniformly recognized that full and accurate disclosure of all material information is vital to the bankruptcy process." *In re Riccardo, 248 B.R. 717, 723-24 (Bankr. S.D.N.Y. 2000)* (Chapter 7). *See also, In re Wincek, 202 B.R. 161, 166 (Bankr. M.D. Fla. 1996)*, *aff'd, 208 B.R. 238 (M.D. Fla. 1996)* (Chapter 13) ("'[F]ull disclosure of all relevant information has always been an important policy of the bankruptcy laws.'"); *Cohen v. McElroy (In re McElroy), 229 B.R. 483, 488 (Bankr. M.D. Fla. 1998)* [*46] (Chapter 7) ("A debtor's complete disclosure is essential to the proper administration of the bankruptcy estate."); *in accord, In re Sharp, 244 B.R. 889, 891-92 (Bankr. E.D. Mich. 2000)* (Chapter 7). The Jay Alix Protocol itself contains comprehensive disclosure requirements in Article I paragraph (e) and subparagraphs thereof, which provides:

> E. The application to retain JAS shall make all appropriate disclosures of any and all facts that may have a bearing on whether JAS, its affiliates, and/or the individuals working on the engagement have any conflict of interest or material adverse interest, including but not necessarily limited to the following:
>
> [subparagraphs 1 through 8]

Consistent with the failure to make adequate disclosure concerning the SW and Huron retention applications, McDermott and, under McDermott's direction, SVCMC were not always forthcoming with documents and information. Two examples are illustrative. One is that McDermott did not provide the U.S. Trustee with a copy of the May 6, 2005 Huron Group Acquisition Agreement and related Employment Agreements for Speltz and Weis until July 22 (the U.S. Trustee testified that she never received these documents from McDermott), [*47] despite the fact that disclosure of these documents was obviously essential for the Trustee to assess the propriety of the July 5 Motions to retain Huron and approve the SW Management Agreement. A second example is the extraordinary shutdown of information, or "radio silence" instruction, issued by McDermott. On August 11, 2005 the Creditors' Committee informed Smith that it intended to object to the debtors' motion to retain SW. The same day Smith sent an email to the debtors' management directing that it cease all communications and information transmittal to the Creditors' Committee, cancel all meetings with the Committee's representatives and "maintain radio silence." Acting on the McDermott "radio silence" instruction, the debtors' management thereafter ceased to provide any information about the debtors' business and operations to the Committee and its professionals. At the same time Smith instructed McDermott attorneys to undertake an investigation of a rumor that the Creditors' Committee had begun to interview candidates to replace the debtors' senior management. The investigation lasted four days, after which McDermott determined that there was insufficient credible evidence [*48] of any "wrongdoing." Only then did Smith instruct the debtors' management to reopen communications with the Creditors' Committee.

The excuses for the failure to timely provide the Huron Acquisition documents -- that the documents were never requested (denied by the U.S. Trustee), or that the U.S. Trustee could have obtained the documents from the Huron Group's Form 8-K SEC filing -- speak volumes as to McDermott's uncooperative or even adversarial approach to the U.S. Trustee's office and the Creditors' Committee, and the firm's apparent failure to understand the necessity of a forthcoming approach in the conduct of a Chapter 11 reorganization, where the achievement of trust, confidence and consensus is the key to success. The "radio silence" incident reflects fundamental misconceptions concerning the stewardship of a Chapter 11 case as debtors' counsel. Open communications and the prompt furnishing of all data and information necessary for other parties to fulfill their fiduciary responsibilities are absolutely essential to the conduct of a Chapter 11 case. Moreover, if the Committee had, in fact, begun to interview candidates to replace Speltz and Weis, there was nothing improper [*49] in the Committee doing so. McDermott's imposition of "radio silence" on the debtors' management while the firm undertook an investigation of whether the Committee had begun to interview candidates was emblematic of McDermott's adversarial and counterproductive representation of the debtors.

McDermott argues that in pursuing the dual retention of Huron and approval of the SW Management Agreement it was simply acting pursuant to the instructions of the SVCMC Board. Thus, McDermott asserts:

> Even after McDermott and St. Clair learned of the UST's concerns about the SW/Huron retentions, and after they discussed those concerns with Richard Boyle ("Boyle"), the Chairman of the Debtors' Board (see Oct. 23, 2006 Tr., 286: 8-11), SVCMC still directed McDermott to get Court approval of the Board/Crowley strategy while the Board and Crowley negotiated with SW and Huron. See July 25, 2005 email from Smith to Boyle, cc: Crowley [Tab 40]; July 25, 2005 email from Boyle to Smith responding to Smith's email [Tab 41] ("Please proceed for Speltz and Weis. The Executive Committee will meet on Friday and, I expect, will approve the actions being taken by Huron and waive the conflict issue."). As Boyle put [*50] it. [sic] "I did not realize that new management was needed until mid-August of 2005." Boyle Aff. [Vol. 4, Exhibit C], P 11.
>
> 30. McDermott cannot be held liable for following the instruction of its client to seek the retentions of the critical SW personnel in these cases -- an instruction that was supported by the Debtors' sound business judgment and reached with the Debtors' full knowledge of the conflicts presented by the SW/Huron relationship. It is unjust to fault McDermott now for merely following the reasoned and informed direction of the Debtors' Board.

But the evidence does not support the conclusion that McDermott's failure in the Huron/SW retention debacle was "merely following the reasoned and informed direction of the Debtors' Board," or that the debtors' persistent pursuit of dual retention in the face of obvious conflicts and derelictions of Speltz and Weis reflected "sound business judgment." In the Debtors' Reply dated October 19, 2006 to McDermott's response to the debtors' objection, the debtors argued their position as follows:

> Rather, the Debtors assert that the relevant questions are what advice and counsel was provided by MWE and to whom was it provided as to the [*51] substantive issues raised in the Debtors' Objection, and in particular, MWE's handling of the S&W retention issues, including its failure to disclose those issues to the Court. ... MWE's purported defense that it was simply taking direction from the "client" (*i.e.,* senior management) is alarming given that the Debtors' senior management was comprised of Messrs. Speltz and Weis, the conflicted parties, (acting as the Debtors' CEO and CFO, respectively), and is borderline absurd. The record is also clear that the Debtors' Board and Elizabeth St. Clair ..., who were not and are not bankruptcy experts, were wholly relying on MWE in these matters and MWE failed to make them completely aware of the seriousness of the issues and the positions of the United States Trustee until very late in the process.

The trial evidence fully supports the debtors' October 19, 2006 argument. The Executive Committee's August 24 decision to fire Speltz and Weis certainly demonstrates that Boyle's July 25 "proceed for Speltz and Weis" email to Smith was neither reasoned nor informed. The evidence compels the conclusion that McDermott did not inform and advise Boyle of the legal and practical realities of the dual [*52] retention and Speltz and Weis conflicts until mid-August.

Smith's direct testimony by affidavit reflects numerous occasions where he gave reports, advice and counsel to Speltz and Weis. But the very first recitation in Smith's affidavit of any advice given to Boyle or the rest of the SVCMC Board appears in paragraph 113 concerning advice given *on July 29.* In paragraphs 114 and 115 Smith states "I conveyed to Speltz, Weis and to St. Clair the concerns expressed by the UST and Committee at the July 21, 2005 meeting" and "I recommended to Speltz and Weis on *July 21, 2005* that the debtors adopt the UST's requests made to me on July 21, 2005. . . ." In paragraph 113 Smith stated "McDermott advised the Board *on or about July 29, 2005,* that McDermott met on July 21, 2005 with the UST and counsel for the Committee" (emphasis supplied). It was not until August that Smith advised Boyle that Speltz and Weis were at the heart of the retention problem. [7] In paragraph 130 Smith states "By the second week of August 2005, I shared with Boyle, the Chairman of the Debtors' Board, my belief that the tenure of Speltz as CEO had become unsupportable. [8] Then came the August 19, 2005 meeting with the UST [*53] and the Committee's counsel at which both demanded the appointment of a Chief Restructuring Officer. Following that seismic event, Smith finally called for a meeting of the Executive Committee of the Board which was held on August 24, at which the Executive Committee fired Speltz and Weis.

7 *See,* for example, Smith's trial testimony on October 23, 2006 at page 230:

> Q. The fight over Speltz and Weiss [sic], as you said, was a sideshow?
>
> A. It began as a sideshow. It became to dominate the reorganization by the end of the summer.
>
> Q. Is it fair to say that uncertainty surrounding the Speltz and Weiss [sic] retention in senior management at St. Vincent's had become a distraction to the entire reorganization process, isn't it?
>
> A. The threats that the committee and the trustee were leveled at St. Vincent's and its advisors make it very difficult about anything approximating the goal of reorganization. The direct threat for me to go tell Huron that they're never going to be paid for any of the services that they rendered, that the trustee's office under no circumstances will ever agree, not for a time and as long as I'm at it, go tell the Speltz and Weiss [sic] people they're never going to be [*54] paid for the work they've done and, by the way, Mr. Smith, I don't think your fee application is going to be treated particularly well either. Yes, that was deeply stabilizing [sic, should read destabilizing] to a reorganization neither with them.

8

Smith's August 11 "radio silence" email to Speltz, Weis and others (but not Boyle) raises a question as to when in the second week of August Smith came to the belief that the tenure of Speltz as CEO had become unsupportable. The August 11 email, set forth in full below, states "our intent" to bring on an application for retention of SW promptly.

> "In conversation this afternoon, I was advised by Comtee counsel that the Comtee will oppose retention of S+W. Marty declined to be more specific, but said that nothing would change his or the Comtee's mind.
>
> "I have notified the UST of this, as well as our intent to bring the application on for hearing promptly. Will liase with Ron Barliant on strategy.
>
> "Effective immediately, please stop ALL communication or information transmittal to the Comtee, can-

> cel ALL meetings with their representatives, and maintain radio silence. If asked, refer inquiries to me. We will attend the meeting next Friday, but it [*55] is an open question who, if anyone, other than Tom Allison and me will go. This does not apply to OCB contacts with Comtee members, such as 1199.
>
> "Lots more will follow, and positions may change, but for now, shut it down."

What is clear from the evidence is that McDermott never advised Boyle or the Executive Committee or the full Board until mid-August 2005 that the dual retention of Huron and SW was *from the outset* a dead letter by reason of the Jay Alix Protocol, *Section 327(a) of the Bankruptcy Code* and the serious conflicts of interest and breaches of fiduciary duty that tainted Messrs. Speltz and Weis from the Huron Group acquisition of SW in early May. This is clear from Boyle's trial affidavit:

> 10. I am not aware of ever being advised by MWE prior to the July bankruptcy filing of the impact that the Huron acquisition would have on SVCMC's ability to retain SW LLC in the bankruptcy action. I was not informed by MWE prior to the bankruptcy of the "disinterestedness" requirement in the Bankruptcy Code as it related to the retention of SW LLC as bankruptcy professionals.
>
> 11. While my confidence in David Speltz and Tim Weis was shaken in May of 2005 because of the Huron acquisition, [*56] I did not realize that new management was needed until mid-August of 2005. Neither I nor the Board became aware of the substantial issues related to the retention of SW LLC until shortly before the August 24, 2005 Board meeting where it was determined that David Speltz and Tim Weis would be asked to resign from SVCMC.

Boyle and other members of the Board undoubtedly saw the Crowley report, but they obviously did not comprehend the significance of the Jay Alix Protocol and the Speltz and Weis taint from the perspective of bankruptcy retention and the disinterestedness requirement under *Section 327*. This is painfully evident from the July 25, 2005 email from Boyle to Smith (relied on to support McDermott's "merely following orders" argument) where Boyle said "Please proceed for Speltz and Weis. The Executive Committee will meet on Friday and, I expect, will approve the actions being taken by Huron and waive the conflict issue." The fact that the Executive Committee or the Board might be willing to waive the Huron/SW conflict, and the Speltz and Weis conflicts and breaches of fiduciary duty, was completely irrelevant from a bankruptcy perspective, because no waiver could be expected from [*57] the Creditors' Committee, or the U.S. Trustee's office, or the Court which is charged by law to enforce the law as written in *Section 327(a)*. [9] Indeed, the Board's waiver had the predictable result of undermining the Committee's and the U.S. Trustee's confidence in the Board itself, leading to the August 19 proposal for a CRO.

9

Section 327 permits retention of professional persons "that do not hold or represent an interest adverse to the estate, and that are disinterested persons." Implementing this provision, the Jay Alix Protocol clearly precluded the dual retention of both Huron and SW after the Huron Group acquisition of SW. For the same reason, the Huron Group/SW acquisition and their employment agreements (not to mention their breaches of fiduciary duty) disqualified Speltz and Weis personally from their positions as senior management of the debtors.

Boyle's trial affidavit and testimony that he was not advised of the gravity of the Huron and Speltz and Weis retention issues or the U.S. Trustee's position relating thereto was confirmed in the testimony of Deirdre Martini, the U.S. Trustee. Martini testified in her deposition (Tab 115 p. 78):

> Q. You said that you had conversations [*58] with Dick Boyle that also led to you concluding that McDermott had not adequately communicated your positions. Do you recall any of those conversations?
>
> A. Yes.
>
> Q. Can you tell me about any of them?
>
> A. Dick Boyle had no idea about my -- the level of my concern in the beginning of the case. He had no idea that I was looking to possibly move for a trustee. He had no idea that the Speltz & Weis issue had risen to such a crescendo. And he just said: "Deirdre, I just didn't know."
>
> Q. Were those discussions after August 24, 2005 when he became the CEO?
>
> A. Yes. This was when Weil Gotshal came in.

Boyle's and Martin's testimony was also corroborated by the trial declaration of St. Clair. SVCMC's Chief Legal Officer testified in her declaration:

> 12. At no time prior to the bankruptcy filing was I informed by MWE of the "disinterestedness" requirement in the Bankruptcy Code as it relates to the retention of professionals. To the best of my knowledge, at no time prior to August 24, 2005 did MWE advise SVCMC's Board of the substantial issues that SVCMC faced in getting Speltz & Weis retained by the Court, including the specific concerns that had been raised by the U.S. Trustee.
>
> 13. In hindsight, it is [*59] clear to me that MWE's single-minded pursuit of the Speltz & Weis retention in the bankruptcy case was extraordinarily destructive to SVCMC's credibility with the constituents in the bankruptcy process, including the Court, the U.S. Trustee and the Creditors' Committee. This is particularly true now, as I have experienced the scrutiny under which such retention is examined by the non-debtor constituents in the bankruptcy process.
>
> 14. Additionally, it is now clear to me that that [sic] MWE's decision to take a strong adversarial position against the U.S. Trustee and the Creditors' Committee did not benefit SVCMC, and resulted in delaying SVCMC's restructuring process. For example, MWE consistently took the position that SVCMC did not need to comply with the "J. Alix Protocol" and that the "J. Alix Protocol" was simply a pretext for the Creditors' Committee to muscle its way into management.

Precisely because Speltz and Weis were conflicted in pursuing the dual Huron/SW retentions for public relations purposes, McDermott had no alternative but to take the matter to the SVCMC Board at the earliest stage possible, preferably even before the July 5, 2005 filing date, to preclude the ultimately [*60] disastrous confrontation with the Creditors' Committee and the U.S. Trustee's office. That was not done. As Boyle put it, "I did not realize that new management was needed until mid-August 2005."

I unequivocally reject McDermott's attempt to place responsibility on Crowley and St. Clair with respect to advising the SVCMC Board concerning the dual retention applications and the conflict issues. St. Clair was not a bankruptcy lawyer. Crowley was retained for a limited purpose which did not include acting as bankruptcy counsel for SVCMC or advising on bankruptcy issues arising in connection with professional retention applications or otherwise. The evidence makes unambiguously clear that everyone, including McDermott, understood that McDermott was responsible for representing the debtors on all matters relating to the bankruptcy proceedings and advising on all bankruptcy matters including bankruptcy retention issues.

III. St. Mary's Hospital closing

Little need be said regarding McDermott's performance on the closing of St. Mary's Hospital.

On June 1, 2005 the SVCMC Board instructed McDermott to work with management to close St. Mary's Hospital as soon as possible. As of June 17, 2005, McDermott [*61] knew that the debtors had set September 1, 2005 as the target for closure of St. Mary's Hospital. McDermott was charged with the responsibility of obtaining Bankruptcy Court approval. St. Clair and other SVCMC staff were responsible for obtaining Department of Health and canonical authority to close the Hospital.

Canonical authority was granted prior to the bankruptcy filing on July 5. Department of Health approval was granted on August 31. Bankruptcy Court approval was not obtained until the September 20, 2005 hearing at which SVCMC was represented by Weil, Gotshal & Manges.

The closing of any medical facility in a big city is almost certain to generate intense and emotional opposition from doctors, other hospital staff and affected local community groups. The Court must be sensitive to such pressures and must grant time and attention to the objecting community voices. Most important, the debtors must provide the Court with a comprehensive, well-documented record of affidavits and supporting exhibits demonstrating to the press, politicians and the public the economic or other facts of life requiring closure.

In order to meet the September 1 deadline set by the Board, it was absolutely [*62] essential for McDermott to prepare and file with the Bankruptcy Court a comprehensive, well-supported motion by the second or third week in July *at the very latest* to have any chance of holding a hearing in August and getting a favorable ruling by the September 1 deadline set by the Board. As shown in the recitation from paragraphs 104-147 of the parties' agreed statement of Undisputed and Admissible Facts, quoted above, McDermott simply did not get the job done.

From June 17 until after July 22, no McDermott attorney was assigned to begin work on a motion for Bankruptcy Court authority to close St. Mary's Hospital. On July 22 Harriet McCloud filed a State Court litigation in Kings County Supreme Court seeking to restrain the Department of Health from approving the St. Mary's Hospital closure plan. The McCloud suit seems to have been the catalyst for McDermott to focus on St. Mary's. A week later, on July 29, McDermott filed a complaint with the Bankruptcy Court to enjoin Ms. McCloud from prosecuting the State Court litigation. The August 4 hearing in the Bankruptcy Court seeking a preliminary injunction concededly was not handled well by McDermott on behalf of the debtors, but the [*63] motion was granted. It was not until August 5 that McDermott attorneys first began work on a motion for Bankruptcy Court approval to close St. Mary's Hospital, and the motion was not filed until August 18. The motion papers were not supported by a single affidavit and did not attach any financial analysis to support the summary and conclusory lawyer assertions in the motion concerning the financial need to close the Hospital. As the chronology shows, this was too little, too late. At the September 7 hearing on the motion to close, the Bankruptcy Court, unsupported by a sufficient record, adjourned the hearing without ruling on the motion.

At the resumed hearing on September 20, with the benefit of four supporting affidavits, prepared under the supervision of Weil as new counsel for the debtors, the Court finally granted the motion.

I reject McDermott's contention that it did not file the St. Mary's Hospital closure motion on July 5, or on July 22 "because the Debtors . . . were not far along enough in the process of obtaining regulatory approval from the Department of Health." No witness at the trial (other than McDermott) supported such a rationale. Nor do the facts and circumstances. [*64] SVCMC publicly announced in June its intent to close St. Mary's Hospital. The debtors' local Rule 1007-2 Statement filed on July 5 expressly stated the debtors' intention to close the Hospital. On July 22 the debtors, on their own, with no participation by McDermott, issued notices to St. Mary's Hospital employees pursuant to the WARN Act. The Selbst trial affidavit to the effect that St. Clair told him to delay the motion because the Department of Health had a strong preference for keeping details relating to the closure confidential until it had finally approved the closure is unsupported by any document, or by St. Clair, or by any witness from the Department of Health. The argument makes no sense, because by mid-July it was widely known public knowledge that SVCMC was seeking to close St. Mary's Hospital. In response to a question by the Court, St. Clair denied ever having a conversation with any lawyer from McDermott in which she asked McDermott, in words or substance, to hold up or refrain from filing a motion in the Bankruptcy Court (Tr. Oct. 24, 2006 p. 64). Nor was Selbst convincing in asserting that the Bankruptcy Court closure motion could not have been completed and filed [*65] before August 18 because McDermott "struggled mightily with the client to verify these . . . numbers . . . the losses, to figure out which contract[s] [would have] to be rejected and to try to address some of the concerns that Judge Beatty had expressed." If work on the motion had been commenced soon after the June 17 Board meeting which set the September 1 deadline, instead of August 5, the motion would have been timely filed. It was the Board that set the September 1 deadline, and it was McDermott's job to do what had to be done to comply with the Board's mandate.

The undisputed fact is that no McDermott lawyers began working on the Bankruptcy Court motion to approve the St. Mary's Hospital closure until August 5, following the impetus of the McCloud State Court litigation. [10] By that time a successful resolution of the motion by September 1 was impossible. Moreover, the motion was unaccompanied by any supporting affidavits or financial analysis to document the economic exigency requiring prompt closure. McDermott's delay in preparing and filing the motion was not the consequence of strategy, but inattention. The failure to support the motion when finally made with affidavits and [*66] financial analysis was not the consequence of strategy or the unavailability of data, but inadequate and untimely preparation.

10 Paragraph 128 of the parties' statement of Undisputed and Admissible Facts states:

> 128. McDermott first began work on a motion seeking permission from the Bankruptcy Court to close St. Mary's Hospital (the "St. Mary's Motion") no earlier than August 5, 2005.

IV. Consequences for the McDermott fee application

At the conclusion of the trial hearing I requested the objecting parties to submit a concise post-trial submission explaining with particularity the dollar consequences for the McDermott fee application which should result from the deficiencies in performance by the McDermott firm with respect to the Huron/SW retention proceedings (including the radio silence instruction) and the delay in filing the debtors' motion to close St. Mary's Hospital. I have carefully considered the objecting parties' Post-Trial Statement of Economic Consequences to Debtors' Estates resulting from McDermott's services, McDermott's Reply, McDermott's submission dated July 19, the objectants' response dated July 30, and McDermott's reply dated August 3. The following are my conclusions [*67] on these issues.

A. SW and Huron retentions

The parties have stipulated in their July 19 and July 30, 2007 submissions that the total of McDermott's fees incurred in connection with the SW and Huron retentions was $ 98,382.25. I conclude that McDermott should receive no compensation in respect of the firm's work in connection with these retentions. These efforts, including the grossly misleading and inadequate July 5 Motions, the improvident July 13 motion, the August 1 withdrawal of the application to retain Huron, and the events leading to the August 24 Executive Committee meeting at which Speltz and Weis were fired were predictably futile from the outset. McDermott should have realized, and advised the Board early in July if not before the filing, that (as Smith advised Speltz and Weis on April 26) "the issues were disinterestedness, the Jay Alix Protocol and conflicts" and that dual retention of both Huron and SW could never receive support from the Creditors' Committee or the U.S. Trustee's office and could never be approved by the Court because of the patent conflict between Huron and SW after the Huron Group acquisition of SW and the very serious conflicts and breaches of fiduciary [*68] duty of Speltz and Weis. The entire retention process from the July 5 Motions to the August 24 Executive Committee meeting resulted in escalating friction and mistrust between the Committee and the U.S. Trustee, on the one hand, and the debtors and McDermott on the other. As Smith testified, the retention issues "[came] to dominate the reorganization by the end of the summer."

In short, the McDermott services relating to retention of professionals, at the time at which those services were rendered, were not only not beneficial to the debtors' estates and not reasonably likely to benefit the debtors' estates -- they were affirmatively detrimental to the debtors' estates. Compensation of $ 98,382.25 in respect of retention services is denied.

B. The tortious interference investigation

The investigation conducted by McDermott during the radio silence instruction was unnecessary and inappropriate and conferred no benefit on the debtors' estates. Compensation for the stipulated $ 44,523 cost of the investigation is denied.

C. Change of management and CRO retention

The parties have stipulated that $ 74,180 of McDermott's fee application represent time charges in connection with the change in [*69] management and CRO retention matters resulting from the firing of Speltz and Weis on August 24, 2005. These matters are inextricably related to the disastrous SW and Huron retention proceedings and events described at length in this Decision. The debtors should not be required to bear this expense and, accordingly, compensation for this $ 74,180 in fees is denied.

D. Transition of counsel from McDermott to Weil

The parties have stipulated that McDermott's application for legal fees includes $ 43,458 in connection with the transition of counsel from McDermott to Weil. As shown in the discussion above, McDermott was terminated by the Board because of the shortcomings in the firm's performance which resulted in a crisis of confidence in SVCMC's management and Board and McDermott on the part of the Creditors' Committee, the U.S. Trustee and the Court. The debtors should not bear that cost. McDermott's billed transition fees of $ 43,457.50 will be deducted from McDermott's fee application.

E. Fees incurred for St. Mary's Hospital closing

On June 1, 2005 the Board instructed McDermott to take the necessary and appropriate action to close St. Mary's Hospital. On June 17 the Executive Committee [*70] set September 1 as the target date for closure of the

Hospital. Smith attended the June 1 Board meeting and the June 17 Executive Committee meeting. Despite these unambiguous instructions from the Board and the Executive Committee, McDermott did not even begin to prepare a motion for Court approval of the Hospital closing until August 5, and the motion was not filed until August 18. The motion as filed was defective because it was not supported by any affidavits or financial data to document the necessity for closing the Hospital. As a direct consequence of this delay, Court approval was not obtained until September 20.

Since canonical authority for the closure had been obtained in late June, and Department of Health approval of the closure was obtained on August 31, McDermott's failure to get the job done in accordance with its instructions from the client resulted in a twenty-day delay in closure of the Hospital.

The parties have stipulated that McDermott's fee application includes $ 248,704 in connection with the closure of St. Mary's Hospital. For the reasons elaborated in point III and summarized just above, I conclude that McDermott's compensation in respect of the St. Mary's Hospital [*71] closure should be reduced by $ 200,000. These services were grossly tardy and the work product was plainly inadequate because it did not provide the Court with a documented, factual predicate necessary for an order to close the Hospital.

To summarize, I conclude that McDermott's services in connection with the St. Mary's Hospital closure were not "performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue or task addressed" within the meaning of *Section 330(a)(3)(D)* and that McDermott's delay in rendering those services was not "beneficial at the time at which the service was rendered" within the meaning of *Section 330(a)(3)(C)*. I further conclude that $ 200,000 is an appropriate amount to deduct from McDermott's $ 248,704 billings for the Hospital closing.

F. Consequential damage claims

The debtors seek a reduction of McDermott fees to offset the damages sustained by SVCMC as a consequence of McDermott's default. The debtors assert that St. Mary's Hospital was losing approximately $ 78,000 per day resulting in a total loss of $ 1,560,000 for the twenty-day delay. I reject McDermott's argument that "there is no proof linking [*72] these purported losses to McDermott's services. This claim is pure speculation" (Reply at 8-9). The fact that St. Mary's Hospital was operated at a loss is neither speculative nor disputed. The precise quantum of loss sustained during this specific twenty-day period may be impossible to quantify with dollar and cents precision on the trial record. But there can be no doubt that the debtors suffered a large loss as a consequence of McDermott's delay in filing the motion. It must be noted that McDermott's position now contrasts sharply with McDermott's representations to the Court in its contemporaneous submissions in August and September 2005. As noted in footnote 5, above, McDermott represented in the August 18, 2005 motion (P 47) that "The continued expense of more than $ 100,000 per day to fund the losses of St. Mary's Hospital operations is simply not justified and threatens the entire SVCMC reorganization." In the Debtors' Omnibus Response dated September 2, 2005 (P 5) McDermott represented to the Court that "St. Mary's Hospital is currently losing more than $ 500,000 per week," which equates to $ 71,428 per day or $ 1,428,560 for a twenty-day delay.

However, the debtors' claim [*73] for consequential damages in connection with the St. Mary's Hospital closing delay is, in substance, a tort claim for professional malpractice. The contested matter before the Court is McDermott's application for legal fees and the objections to McDermott's fees filed by the objecting parties. In my view it is inappropriate to litigate a tort claim for malpractice in the guise of an objection to legal fees. The standards for determining the merits of a malpractice claim and the quantum of damages to be awarded, if any, are not necessarily the same as the standards for determining the appropriateness of legal fees under the Bankruptcy Code.

Accordingly, I deny the debtors' request to reduce McDermott's legal fee application by reason of consequential damages resulting from delay in the St. Mary's Hospital closing, without prejudice to the debtors' right to assert such damages in an appropriate malpractice action or proceeding.

Similarly, the debtors seek to recover (by deduction from McDermott's fee application) $ 230,000 in legal fees payable to Weil to obtain Bankruptcy Court approval to close St. Mary's Hospital and $ 120,000 of Weil legal fees for the transition. These costs also [*74] represent putative consequential damages. They may, or may not, be awarded as damages in a malpractice action, but they may not be recovered in an objection to McDermott's legal fees. Accordingly, these claims also are denied, without prejudice.

Conclusion

Upon the foregoing, the objections to McDermott's fee application are sustained to the extent of $ 460,543, consisting of $ 98,382 in respect of the SW and Huron retentions, $ 44,523 for the tortious interference investigation, $ 74,180 for change of management and CRO retention, $ 43,458 for McDermott's fees for transition of counsel, and $ 200,000 of McDermott's fees relating to the St. Mary's Hospital closing. The objections are sustained to the extent set forth herein and overruled to the extent that the objectants sought a greater reduction in McDermott's legal fees. Debtors' counsel will submit an order consistent with this Decision, approved as to form by all parties but without prejudice to any party's right to appeal.

Dated: White Plains, NY

August 29, 2007

/s/Adlai S. Hardin, Jr.

U.S.B.J.

In re CASCADIA PROJECT LLC, Debtor.

Chapter 7, Bankruptcy No. 09-20780

UNITED STATES BANKRUPTCY COURT FOR THE WESTERN DISTRICT OF WASHINGTON

2011 Bankr. LEXIS 1937

May 26, 2011, Entered on Docket

NOTICE: NOT FOR PUBLICATION

COUNSEL: [*1] For Cascadia Project LLC, dba Cascadia, dba Cascadia EBPC, Debtor: Miller Nash LLP, Geoffrey Groshong, Seattle, WA; Adam G Hughes, Daniel Brown, Danielle M Cross, Miller Nash LLP, Seattle, WA; William L Beecher, Beecher & Conniff, Tacoma, WA.

For Michael B. McCarty, Trustee: James F Rigby, The Rigby Law Firm, Seattle, WA.

For United States Trustee, US Trustee: Thomas A Buford, Seattle, WA.

For Official Committee of Unsecured Creditors, Creditor Committee: Cairncross & Hempelmann PS, Seattle, WA; Deirdre Glynn Levin, John Knapp, John R Rizzardi, Cairncross & Hempelmann PS, Seattle, WA.

JUDGES: Karen A. Overstreet, United States Bankruptcy Judge.

OPINION BY: Karen A. Overstreet

OPINION

MEMORANDUM DECISION

This matter came before the Court on March 18, 2011, on the Final Application for Compensation and Reimbursement of Expenses (the "Application"), filed by Obsidian Finance Group, LLC ("Obsidian"), the financial advisor to the debtor, Cascadia Project LLC (the "Debtor"). Dkt. 634. HomeStreet Bank ("HomeStreet"), the Debtor's largest secured creditor, filed the only objection to the Application. [1] At a hearing on the Application on March 18, 2011, the Court invited the parties to file additional pleadings addressing whether [*2] Obsidian had a conflict of interest which might mandate disallowance of all or part of the fees sought. Obsidian and HomeStreet filed supplemental briefs and declarations, which the Court has considered, in addition to the initial pleadings filed in support of and in opposition to the Application. *See* Dkt. 655, 656, 657, 658.

1 At the hearing, the Court made an orally ruled that HomeStreet has standing to oppose the Application. The oral ruling is incorporated in this Memorandum Decision by this reference.

For the following reasons, the Court finds that Obsidian had a conflict of interest as of May 17, 2010, when it agreed to acquire an ownership interest in the Debtor, and that its fees and costs incurred on and after that date should be denied.

I. FACTS

The Debtor filed its voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code [2] on October 15, 2009. On December 4, 2009, the Debtor submitted an application for authorization to employ Obsidian as its financial advisor. As set forth in the Application and the Declaration of Kevin Padrick, senior principal and co-founder of Obsidian, Obsidian did not hold an adverse interest to the estate, and it was considered [*3] a disinterested person under *Bankruptcy Code ß 327(a)*. [3] Application to Employ, Dkt. 91; and Declaration of Kevin Padrick, Dkt. 92. On January 28, 2010, the Court entered an order approving the employment of Obsidian as a financial advisor. Dkt. 188. Pursuant to the order, Obsidian was appointed "to perform all services necessary to effectively assist and advise the Debtor with regard to financial issues and other matters set forth in the Application or as may otherwise become necessary." *Id*. at ∂2. Further, the order approved an alternative form of compensation, whereby Obsidian would discount its hourly rates charged to the bankruptcy estate by 50% in exchange for a success fee to be paid after confirmation that would be equal to three times the total amount of its 50% hourly rate reduction. *Id*.

2 Unless otherwise indicated, all Code, Chapter, Section and Rule references are to the Bankruptcy Code, *11 U.S.C. ßß101 et seq.* and to the *Federal Rules of Bankruptcy Procedure, Rules 1001 et seq*.

3 The Application to Employ disclosed that Kevin Padrick was a former partner of Miller Nash, counsel representing the Debtor. Thus, counsel for the Official Committee of Unsecured Creditors (the "Committee") [*4] in this case has filed various pleadings, including the Application, on behalf of Obsidian.

On February 9, 2010, the Committee filed a Supplemental Declaration of Kevin Padrick, whereby it was disclosed that Obsidian engaged the law firm of Ball Janik LLP, counsel for HomeStreet, the major secured creditor in the case, as its counsel on matters unrelated to the bankruptcy case. First Supplemental Declaration of Kevin Padrick, Dkt. 201. On March 23, 2010, the Court entered an order awarding Obsidian compensation for services in the amount of $131,774 and reimbursement of expenses in the amount of $4,837.79. Dkt. 240. Of the amount awarded, $66,399.24 remains unpaid.

The Debtor filed its Chapter 11 Plan of Reorganization (the "Plan") and Disclosure Statement on May 31, 2010. Dkt. 333, 334. Attached to the Plan was a Letter of Intent for Acquisition and Funding of the Cascadia Project LLC ("LOI") dated May 28, 2010, among TPG Opportunities Partners, L.P. ("TPG"), Yarrow Bay Holdings ("Yarrow Bay"), and Obsidian. According to the LOI, TPG, Yarrow Bay, and Obsidian were to acquire 100% of the equity interest in the Debtor and to jointly contribute up to $55 million to fund the Plan. Obsidian's [*5] proposed contribution under the LOI was 2% of the total investment, equating to $1.1 million. Additionally, the acquisition of the Debtor's equity interest was to be accomplished through a newly formed limited liability company owned by the three investors. Section 3 of the LOI provided that the reorganized debtor would be managed by a newly created servicing entity owned 60% by Yarrow Bay and 40% by Obsidian (the "Servicing Entity"). The Servicing Entity would provide day-to-day servicing of the project in exchange for a monthly fee of $75,000 plus bonuses. Dkt. 333, Exhibit 1. [4]

4 On June 19, 2010, the Debtor filed its First Amended Chapter 11 Plan of Reorganization, attached to which was the LOI. Dkt. 445. The amended plan was in substance no different than the Plan as the terms related to the transactions at issue here, accordingly, the Court will refer hereinafter only to the Plan.

On June 14, 2010, HomeStreet filed a Motion to Disqualify Obsidian as the Debtor's financial advisor on the ground that Obsidian's status as an investor in the reorganized debtor under the Plan created a conflict of interest rendering Obsidian disinterested under *Section 327(a)* (the "Motion to Disqualify"). [*6] Dkt. 400. Three days later, on June 17, 2010, Mr. Padrick filed a Second Supplemental Declaration regarding Disclosure of Connections by Obsidian, disclosing Obsidian's role under the LOI. Dkt. 426. Specifically, the declaration disclosed that Obsidian would be an investor under the Plan and be a servicer for the ongoing operations of the reorganized debtor. *Id*.

At the evidentiary hearing on HomeStreet's Motion for Relief from Stay (the "Evidentiary Hearing"), held June 22 through 24 of 2010, Mr. Padrick testified extensively. Over hours of questioning, he took the Court and the parties through the complicated and detailed business model constructed by Obsidian for the development of the Cascadia planned community. He testified that Cascadia's 4,400 acre parcel would ultimately be developed into one of the largest employment-based, planned communities in the State of Washington and that it would include the development of residential, commercial, business and educational properties in conjunction with the development of an adjacent property as a golf course and resort community consisting of 514 acres. Mr. Padrick testified that the project contemplated as many as 40,000 people living [*7] and/or working in the Cascadia community. The development model was dependent upon the funding to be provided by the investors, including Obsidian, under the LOI.

On the first day of the Evidentiary Hearing, Mr. Padrick testified that at a meeting with representatives of TPG on May 17, 2010, TPG made it a condition of any investment in the Debtor by TPG that Obsidian also participate as an investor. Prior to this meeting, according to Mr. Padrick's testimony, Obsidian had no intention to act as an investor under the Plan. Mr. Padrick further testified that pursuant to the LOI and the Plan, if confirmed and performed, Obsidian would realize approximately $28 million on its $1.1 million investment in the reorganized debtor. Mr. Padrick testified that after the May 17, 2010 meeting with TPG, he consulted with the Debtor's counsel and the Committee's counsel before committing Obsidian to be an additional investor in the Debtor and owner of the Servicing Entity under the LOI.

At the conclusion of the Evidentiary Hearing, the Court found that the Debtor had proved it had a reasonable possibility of confirming the Plan within a reasonable time and that HomeStreet's motion for relief from stay [*8] should be denied. The Court's conclusion required an examination of the feasibility of Obsidian's development model and was based largely on the substantial testimony provided by Mr. Padrick in support of the Plan and the development model. The Court's decision to deny relief from stay even though the LOI was contingent at the time of the Evidentiary Hearing was based almost entirely on Mr. Padrick's opinion that there was a "70% likelihood" that TPG would enter into binding agreements incorporating the then contingent terms of the LOI.

The hearing on HomeStreet's objection to Obsidian's continued service as the Debtor's financial advisor was not scheduled to be heard until after the conclusion of the Evidentiary Hearing, which concluded on June 24, 2010, with the Court's oral ruling. Accordingly, the Court made no findings in connection with the Evidentiary Hearing concerning whether a conflict had arisen with respect to Obsidian's service as the Debtor's financial advisor. Unfortunately for the Debtor, TPG ultimately declined to enter into binding agreements with the Debtor, Yarrow Bay and Obsidian, and HomeStreet renewed its motion for relief from stay on August 1, 2010. Dkt. 528. [*9] According to the Debtor's response to HomeStreet's renewed motion, TPG was willing to commit to only 50% of its proposed investment under the LOI, which was $49.5 million (90% of the total of $55 million). The Debtor's response, which was supported by the Declaration of Kevin Padrick, requested the Court to grant Obsidian additional time to find another investor to make up the difference in funding. Dkt. 540. By the time of the hearing on HomeStreet's renewed motion for relief from stay on August 6, 2010, the Debtor had not secured an additional investor and the Court granted HomeStreet's motion that same day. Dkt. 545.

At the time HomeStreet filed the Motion to Disqualify, it also filed a motion to shorten the time for a hearing, requesting that the motion be heard on June 16, 2010, before the commencement of the Evidentiary Hearing. Dkt. 396. The Debtor objected to shortening the time for hearing on the Motion to Disqualify (Dkt. 406), and the Court conducted a special hearing on June 16, 2010. After considering the arguments of all parties, the Court declined to shorten the time for hearing on the Motion to Disqualify and instead ordered that the hearing be continued to July 23, [*10] 2010. The Court indicated that if Obsidian, which had just obtained separate counsel, wanted the Motion to Disqualify to be heard before July 23, Mr. Padrick could agree to that and set it on the calendar with the concurrence of HomeStreet.

No request to hear the Motion to Disqualify prior to July 23, 2010, was ever made by Obsidian. Instead, at a status conference held on July 16, 2010, in anticipation of a settlement between HomeStreet and the Debtor (with funding by TPG), the parties asked to continue the hearing on the Motion to Disqualify to August 27, 2010. After TPG declined to go forward again and the Court granted HomeStreet's motion for relief from stay on August 6, 2010, however, HomeStreet struck the hearing on the Motion to Disqualify.

The Application seeks compensation for services and reimbursement of fees and expenses incurred by Obsidian as the Debtor's financial advisor from February 1, 2010 through September 22, 2010 in the amount of $673,174.26. HomeStreet objected to the Application and argues that Obsidian acquired an interest adverse to the Debtor's estate mandating the Court's disallowance of all fees and costs requested.

II. DISCUSSION

Bankruptcy Code ß330(a), [*11] in relevant part, provides that the court may award a professional person employed under *Section 327* or *Section 1103* reasonable compensation for actual, necessary services rendered and reimbursement for actual, necessary expenses incurred. *Section 328(c)* permits the court to deny allowance of compensation for services and reimbursement of expenses of a professional person if, at any time during the professional's employment, they are not a "disinterested person," or represent or hold an interest adverse to the interest of the estate with respect to the matter on which they have been employed.

Under *ß327(a)*, the court-appointed professional must be "disinterested," and must not represent or hold any interest adverse to the estate. The term "disinterested" is defined under *Section 101(14)* to mean a person who "is not a creditor, an equity security holder, or an insider" and who "does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason." In the Ninth Circuit, the test for determining whether [*12] a professional has an interest that is materially adverse to the estate so as to not qualify as disinterested requires an objective, fact-driven inquiry into the totality of circumstances. *In re AFI Holding, Inc., 530 F.3d 832 (9th Cir. 2008)*. The term "disinterested" is broad enough to disqualify anyone from being employed as a professional who might have the slightest degree of interest or relationship that "would even faintly color the independence and impartial attitude required by the Code." *Id. at 838, quoting In re AFI Holding, Inc., 355 B.R. 139 (9th Cir. BAP 2006)*. The phrase "hold or represent an interest adverse to the estate" is not defined in the Code, but has been interpreted by courts 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. *In re Crivello, 134 F.3d 831, 835 (7th Cir.1998)*. The statutory requirements of disinterestedness and lack of adverse interest serve the important policy of ensuring that all professionals [*13] appointed pursuant to the Code serve the estate with undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities. *Id. at 835-36*.

In this case, Obsidian was employed as the Debtor's financial advisor, and the services to be provided were broad. It was contemplated that Obsidian would provide not only financial advice, but would also develop strategies for reorganization and work with creditors and potential investors to raise equity to fund the plan of reorganization. Because the Debtor is a single asset real estate debtor, it was under immense pressure to propose a plan within an expedited period of time. The aggressive, but entirely lawful, actions by HomeStreet as the Debtor's major secured creditor to enforce its rights limited the time and ability of the Debtor to develop reorganization alternatives. Obsidian embarked upon the preparation of a complicated and detailed business model for development of the project that could be marketed to potential investors. Having constructed that model, Obsidian was intimately familiar with the risks associated with any investment in the reorganized debtor. The investment Obsidian ultimately [*14] agreed to make under the LOI was substantial.

Obsidian contends that its agreement to invest in the reorganized debtor did not create an interest materially adverse to the estate and thereafter it could remain disinterested, despite it's new role as an investor, because it agreed to subordinate any return on its investment or profit to the full payment of all creditors of the estate. It argues that even as an investor, Obsidian's interests were fully aligned with the interests of the estate, each with the goal of maximizing the return to creditors. HomeStreet counters that Obsidian's assumption of the role of buyer of estate assets created a direct conflict of interest, and its agreement to subordinate payment of its financial return to the payment of creditors is irrelevant.

The Court agrees with HomeStreet that under the circumstances of this case, Obsidian's dual role as investor and financial advisor went beyond a mere hypothetical conflict and instead gave rise to an actual and material conflict with the interests of the estate. That conflict was not eliminated or even ameliorated by Obsidian's agreement to subordinate the return on its investment to payment to creditors. As the [*15] Debtor's financial advisor, Obsidian could realize its success fee under its employment agreement only if a reorganization plan was confirmed. If the Plan had been confirmed, that success fee would have approximated $2 million. If the Plan had been confirmed and was fully performed, Obsidian would realize, in addition to its success fee and its administrative expense claim for compensation and expenses, an estimated $28 million return on its equity investment in the Debtor. Once tied to TPG under the LOI, Obsidian was bound to pursue that option to the exclusion of other options that might have been available to the Debtor. Mr. Padrick testified at the Evidentiary Hearing and argues here that TPG was the Debtor's only option. Given Obsidian's conflict, however, the Court finds Obsidian's "independence and impartial attitude required by the Code" more than faintly compromised on and after May 17. 2010.

The cases cited by Obsidian in support of its contention that the seller-buyer role does not give rise to an actual conflict under the facts of this case are not persuasive. Instead, the Court is persuaded by the analysis of the Fifth Circuit Court of Appeals in *In re West Delta Oil Co., Inc., 432 F.3d 347 (5th Cir. 2005)*. [*16] In that case, the court held that an attorney who represented the debtor could not seek to acquire a financial interest in the entity proposing to acquire the debtor. Under the facts of that case, unlike this case, the attorney never signed an agreement to acquire that interest. The court there noted "[w]hile they [the professionals] failed in their effort to acquire an interest in West Delta [the debtor], this failure was not for lack of effort" and it concluded that the bankruptcy court's determination that the professionals' interest was contingent ignored "the reality that both [professionals] testified to taking affirmative steps in an effort to acquire a valuable financial stake in their client. The ultimate success of these efforts is irrelevant-the active pursuit of success is sufficient to give rise to an adverse interest here." *Id. at 357*.

In this case, not only did Obsidian sign the LOI obligating it to acquire an ownership interest in the reorganized debtor, it was at the same time negotiating the terms of the arrangement between the Debtor and TPG. From May 17, 2010, when Obsidian agreed to become an investor, until May 31, 2010, when the Debtor filed the Plan and disclosed [*17] the interest of Obsidian in the LOI, Obsidian was negotiating the return on its investment, its share of the servicing fee, and its interest in the Servicing Entity, all on *its own behalf*. This clearly gave rise to a conflict with regard to its simultaneous negotiation of the terms of the LOI as it would affect the Debtor and the creditors of the estate. Evidence of actual prejudice to the estate is irrelevant, because it is difficult to prove and because the problem is not just "actual evil results" but also the "tendency to evil." *Woods v. City of Nat'l Bank & Trust Co., 312 U.S. 262, 268, 61 S. Ct. 493, 85 L. Ed. 820 (1941)*. Under the facts of this case, given Obsidian's conflict, the Court must deny compensation to Obsidian for the period during which it had an actual conflict of interest.

That counsel for the Debtor and for the Committee acquiesced in Obsidian's dual rule does not negate the requirements of *Sections 327(a)*, *328(c)*, and *101(14)*. Similarly, the fact that the Court did not intervene *sua sponte* and issue an order to preclude further work by Obsidian does not save Obsidian from denial of compensation. Obsidian and Mr. Padrick are sophisticated parties who specialize in transactions involving distressed [*18] companies and properties. They are fully aware of the statutory requirements of the Code and as far as the Court is concerned are fully capable of determining when they want to abandon their role as an estate advisor in favor of a potentially lucrative role as an estate investor. If Obsidian desired a ruling from the Court it could have objected to the Motion to Disqualify and brought the matter to the Court for hearing. Instead, Obsidian either acquiesced in or encouraged HomeStreet to withdraw the motion after the Court granted HomeStreet's motion for relief from stay.

Obsidian contends that its full disclosure of its involvement in the Plan somehow rids it of the conflict of interest. *Rule 2014-1(a)* requires any professional applying for employment to set forth "to the best of the applicant's knowledge" all known connections of the applicant with the "debtor, creditors, or 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." While this provision does not explicitly require ongoing disclosure, case law has uniformly held that under *Rule 2014-1(a)*, (1) full disclosure is a [*19] continuing responsibility, and (2) a professional is under a duty to promptly notify the court if any potential for conflict arises. *See In re Metropolitan Environmental, Inc., 293 B.R. 871, 887 (Bankr.N.D.Ohio 2003)*. *See also In re West Delta Oil Co., Inc., supra.* A professional's failure to fully disclose relevant information as required under the Bankruptcy Code and Rules may result in denial of all requested compensation for a professional fee applicant. *In re Park-Helena Corp., 63 F.3d 877, 881 (9th Cir. 1995)*.

In this case, Obsidian failed to disclose it's conflict under *Rule 2014* immediately when it arose on May 17, 2010. Instead, the conflict was not disclosed until after HomeStreet filed its Motion to Disqualify on June 14, 2010. By that time, Obsidian had been acting simultaneously as the estate's financial advisor and as a proposed investor in the Debtor for a month and the path to the Debtor's reorganization was fixed with TPG for purposes of the upcoming Evidentiary Hearing. Accordingly, the Court finds that Obsidian's belated disclosure does not absolve it of the consequences of the conflict of interest.

The Court has considerable discretion in fashioning a remedy under [*20] the circumstances of this case, including the denial of all fees and costs requested by Obsidian. *See In re Ponce Marine Farm, Inc., 259 B.R. 484 (D. Puerto Rico 2001)*. The Court finds, however, based upon the uncontroverted testimony of Mr. Padrick, that prior to May 17, 2010, Obsidian was a disinterested professional acting in the interest of the estate. Thus, the Court concludes that denial of all fees and costs incurred by Obsidian is not warranted.

CONCLUSION

For the foregoing reasons, the Court finds that as of May 17, 2010, Obsidian had an actual conflict of interest with the interests of the estate and that compensation and expenses incurred on and after that date must be denied. Obsidian shall calculate the amount of the fees to be disallowed pursuant to this Memorandum Decision and submit an order consistent with this Memorandum Decision.