

The following article appeared in *American Bankruptcy Institute*

Disclosure in Fiduciary Representations

by **Peter A. Ivanick**

I. The Disclosure Problem

Attorneys and other professionals retained by debtors, trustees and officially constituted creditor, bondholder and equity committees, for the purpose of representing those entities in bankruptcy cases, have an ongoing obligation to disclose their relationships with parties in interest involved in the case. This obligation derives from section 327 of the Bankruptcy Code (section 1103(b) of the Bankruptcy Code in the case of committee representations) and Rule 2014 of the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”).

While the extent to which lawyers are required to disclose their connections with entities involved in bankruptcy cases has always been an issue open to debate, three recent highly publicized bankruptcy court decisions, described below, have effectively silenced the debate and imposed severe sanctions on the three law firms that failed to disclose adequately their relationships with significant interested parties in these cases. This paper first describes the statutory, procedural and judge-made law that mandates disclosure. It then describes the three recent bankruptcy court decisions that have clarified the disclosure landscape. Finally, the paper describes the disclosure checklist created by a team of Dewey & LeBoeuf bankruptcy lawyers during a year-long effort to ensure adequate disclosure in light of the recent court decisions.

A. The Duty to Disclose

Section 327(a) of the Bankruptcy Code provides that an lawyer being retained by a debtor or trustee must be a “disinterested person” and must not possess an interest that is adverse to the bankruptcy estate. 11 U.S.C. § 327(a). Section 101(14) of the Bankruptcy Code defines “disinterested person” as a person who is not (a) a creditor, equity security holder or insider of the debtor, (b) an investment banker for any outstanding security of the debtor or for any security of the debtor during the three years prior to the filing of the bankruptcy petition, (c) an lawyer for an investment banker in connection with the offer, sale or issuance of

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a security of the debtor during the three years prior to the bankruptcy filing, (d) a director, officer or employee of the debtor or an investment banker of the debtor for two years prior to the bankruptcy filing and (e) “materially adverse” to the bankruptcy estate. 11 U.S.C. § 101(14).

The term “adverse interest” is not defined in the Bankruptcy Code but has been interpreted by courts as meaning (a) to possess or assert an economic interest that would tend to lessen the value of the bankruptcy estate or would create an actual or potential dispute with the estate as a rival claimant, or (b) to possess a predisposition of bias against the estate. *See, e.g., In re Crivello*, 134 F.3d 831, 835 (7th Cir. 1998), citing *In re Roberts*, 46 B.R. 815, 827 (Bankr. D. Utah 1985), *rev’d in part on other grounds*, 75 B.R. 402 (D. Utah 1987); *In re Granite Partners, L.P.*, 219 B.R. 22, 33 (Bankr. S.D.N.Y. 1998). The term generally includes any interest or relationship “that would even faintly color the independence and impartial attitude required by the Code and Bankruptcy Rules”. *In re Roberts*, 46 B.R. at 828, n.26. An actual conflict involves the representation of “two presently competing and adverse interests,” while a potential conflict occurs where the competition “may become active if certain contingencies arise”. *In re Granite Partners, L.P.*, 219 B.R. at 33, quoting *In re American Printers and Lithographers, Inc.* 148 B.R. 862, 866 (Bankr. N.D. ILL 1992). The more recent trend focuses on concerns of divided loyalties and affected judgments. *In re Granite Partners, L.P.*, 219 B.R. at 33. Thus, a professional has a disabling conflict if it has “either a meaningful incentive to act contrary to the best interests of the estate and its sundry creditors — an incentive sufficient to place those parties at more than acceptable risk — or the reasonable perception of one”. *In re Granite Partners, L.P.*, 219 B.R. at 33, quoting *In re Martin*, 817 F.2d 175, 180 (1st Cir. 1987); *accord In re The Leslie Fay Cos.*, 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994). The disinterestedness requirement and the requirement that the professional not have an interest adverse to the estate apply both at the time of retention and throughout the case. *Rome v. Braunstein*, 19 F.3d 54, 62 (1st Cir. 1994); *In re Granite Partners, L.P.*, 219 B.R. at 32; *In re Caldor, Inc.*, 193 B.R. 165, 171 (Bankr. S.D.N.Y. 1996). Section 1103 of the Bankruptcy Code, however, requires that committee counsel not possess any interest that is materially adverse to the estate but does not require that counsel be “disinterested”. 11 U.S.C. § 1103(b).

Rule 2014 of the Bankruptcy Rules requires that lawyers seeking bankruptcy court authorization for fiduciary representations disclose any relationships with the debtor, creditors and other parties in interest to enable the bankruptcy judge to determine whether the lawyer is a disinterested person without an interest adverse to the estate.¹ Bankruptcy Rule 2014. Moreover, lawyers seeking court authorized retention “cannot usurp the court’s function by choosing, *ipse dixit*, which connections impact disinterestedness and which do not” and must, instead, present the relevant information to the court and other parties for an objective determination of disinterestedness. *In re The Bennett Funding Group, Inc.*, 226 B.R. 331, 335 (Bankr. N.D.N.Y. 1998), quoting *In re Granite Partners, L.P.*, 219 B.R. at 35. It is the court that is “in the best position to gauge the ongoing interplay of factors and to make

1. Rule 2014(a) provides: *Application for and Order of Employment*. An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to § 327, § 1103, or § 1114 of the Code shall be made only on application of the trustee or committee. The application shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States trustee. The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant’s knowledge, all of the person’s connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. The application shall be accompanied by a verified statement of the person to be employed setting forth the person’s connections with the debtor, creditors, 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.

the delicate judgment calls which such a decision entails”. *In re The Bennett Funding Group, Inc.*, 226 B.R. at 335 quoting *In re Martin*, 817 F.2d at 182. Accordingly, and as the three cases described below also suggest, lawyers are strongly advised to err on the side of full disclosure if they have any question whatsoever as to whether or not to disclose a relationship.

B. The Scope of Disclosure.

Three recent cases have clarified the extent to which lawyers must disclose the existence of their relationships with parties in interest and demonstrate the severity of the consequences for failure to provide adequate disclosure. These cases have dramatically altered the way that prudent law firms approach disclosure, by highlighting, in a highly public manner, the severe criminal and economic sanctions that can be imposed upon even the most prestigious law firms and influential lawyers.

1. The Granite Partners Cases

In 1994, Willkie Farr & Gallagher (“Willkie Farr”) was retained as counsel to Harrison J. Goldin, as chapter 11 trustee of the Granite Partners cases for, *inter alia*, the purpose of investigating possible causes of action against broker-dealers, including Merrill, Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch). At the time of its retention, Willkie Farr never disclosed to the Court that it simultaneously represented Merrill Lynch. Instead, it merely stated, in an affidavit, that it had previously represented parties in interest on unrelated transactions and might represent them in the future on unrelated transactions, but that it had no current connection with the debtors, their creditors or any other party in interest. *In re Granite Partners, L.P.*, 219 B.R. at 28. The affidavit also stated that Willkie Farr had client relationships, including relationships with certain broker-dealers, but that it had not and would not represent any such parties in connection with the bankruptcy cases. *Id.*

During 1995 and 1996, notwithstanding its representation of the chapter 11 trustee, Willkie Farr opened approximately 400 new matters for Merrill Lynch for which it collected fees in excess of \$9 million during that period. *Id.* at 28. Willkie Farr did not disclose its increased representation of Merrill Lynch to the Court until after it filed its final fee application in 1997. *Id.* at 29. It also failed to disclose that Merrill Lynch had refused to sign a written conflicts waiver, purportedly as a matter of corporate policy, and that an oral waiver given by Merrill Lynch extended only to the investigation of possible causes of action against Merrill Lynch but did not include a waiver with respect to prosecution of any causes of action (notwithstanding the fact that one of the reasons for Willkie Farr’s retention was the investigation and possible prosecution of causes of action against Merrill Lynch and other broker-dealers). *Id.* at 29, 30. The affidavit also failed to disclose that Willkie Farr would not sue Price Waterhouse, the debtors’ auditor and a subject of the trustee’s investigation, on the grounds that Willkie Farr represented the American Institute of Certified Public Accountants. *Id.* at 32.

The Court stated that Willkie Farr had represented interests adverse to the estates and had a meaningful incentive, or the perception of one, to act contrary to the interests of the estates. *Id.* at 36. Moreover, the Court expressed concern with whether Willkie Farr’s relationship with Merrill Lynch tainted its investigation in light of the fact that “Merrill Lynch was a significant and valuable client of Willkie Farr”. *Id.* The Court stated that Willkie Farr’s conflicts were exacerbated by its failure to disclose its relationship with Merrill Lynch and that the clear import of the Willkie Farr affidavit was that Willkie Farr did not currently represent any parties in interest or broker-dealers and did not have an existing

client relationship with Merrill Lynch, which statements, the Court noted, were not true. *Id.* at 38. The Court also noted that Willkie Farr's refusal to sue Price Waterhouse itself constituted a disqualifying adverse interest and should have been disclosed at the outset. *Id.* at 40.

The Court concluded that Willkie Farr was not entitled to any of the approximately \$2.1 million in fees that it generated for its investigative services. *Id.* at 42. Moreover, the Court disallowed 15 percent of the \$2.57 million in fees for non-investigative bankruptcy services sought by Willkie Farr, reflecting the fact that Willkie Farr's conflict and disclosure problems crossed over the line to non-investigative services. *Id.* at 44. Ultimately, Willkie Farr was awarded net fees of \$1.9 million, slightly more than 41 percent of the total fees sought. *Id.*

2. The Leslie Fay Companies

Weil, Gotshal & Manges (Weil) was retained by Leslie Fay pre-bankruptcy to assist its audit committee in the investigation of certain accounting irregularities. The members of the audit committee included Michael Tarnopol, who was also a senior officer of Bear Stearns, and Steve Friedman, a senior manager of Odyssey Partners. *In re The Leslie Fay Cos.*, 175 B.R. at 527. Weil subsequently served as Leslie Fay's bankruptcy counsel. Weil's Rule 2014 statement did not disclose the fact that Bear Stearns and Odyssey were valuable clients of Weil, or that Weil had represented Mr. Friedman personally in the past. Nor did Weil disclose its attorney-client relationship with BDO Seidman, the auditor that had certified Leslie Fay's false financial statements. *Id.* at 529. Each of these parties were potential targets of the investigation and were parties against whom Weil later admitted it would not commence suit without their consent. Finally, Weil did not disclose its attorney-client relationship with Forstmann & Co. (Leslie Fay's seventh largest creditor and a member of the Creditors Committee until it sold its claim). *Id.* at 530.

The Court found that Weil "had an adverse interest because it had an incentive to discount any possible liability so as to preserve its substantial client relationships with the firms of which the directors were principals". *Id.* at 535. The Court initially reviewed the potential/actual conflict dichotomy in the case law and concluded that it is more productive to ask whether a professional has either a meaningful incentive to act contrary to the best interests of the estate and its creditors, an incentive sufficient to place those parties at more than an acceptable risk, or the reasonable perception of one. *Id.* at 533. The Court noted that the Leslie Fay bankruptcy was a direct consequence of fraud and that Weil's failure to disclose its significant ties to three potential targets of the fraud investigation had made it impossible for the Court to consider whether the firm had disabling conflicts. *Id.* at 534. The Court found that Weil had "a perceptible economic incentive not to pursue the possibility of claims against Tarnopol and Friedman with the same vigor and intensity it might have otherwise applied". *Id.*

The Court also found that Weil was not disinterested with respect to BDO Seidman. *Id.* at 535. The Court stated "that the client may not be a major client is not reason to think that Weil Gotshal would ignore the relationship". *Id.* Moreover, the Court noted that the size of the billing is irrelevant because Weil admitted that it would not have sued BDO Seidman even had the facts warranted that a suit be filed, on the grounds that Weil represented accountants and, as a matter of policy, did not sue accountants. *Id.* The Court stated that Weil's failure to disclose this information to the U.S. Trustee or the Court was "an omission that is simply inexcusable". *Id.* Finally, with respect to Forstmann, the Court found that Weil's representation of Forstmann on unrelated matters did not constitute an actual conflict of interest although Weil was wrong to keep secret its connection with Forstmann. *Id.* at 536.

The Court noted that even if Forstmann had become the subject of a claims objection or avoidable transfer action, other counsel, such as Parker Chapin (the debtors' general counsel), could have handled the matter and that any possible problem with Forstmann did not go to the heart of the Weil representation. *Id.*

In light of the examiner's findings, the Court sanctioned Weil, in the amount of approximately \$1 million. The Court also limited Weil's ongoing role in the case to only those matters on which it was already working. *Id.* at 539.

3. Bucyrus - Erie Co.

Milbank, Tweed, Hadley & McCloy, which served as bankruptcy counsel in 1994 for Bucyrus-Erie Co., a Milwaukee manufacturer of mining equipment, did not disclose to the bankruptcy court that it simultaneously represented Mikael Salovaara, who managed South Street Corporate Recovery Fund I, L.P., South Street Leveraged Corporate Recovery Fund, L.P. and South Street Corporate Recovery Fund I (International) (collectively the "South Street Funds"), key secured creditors of Bucyrus. *Jackson National Life Ins. Co. v. Greycliff Partners, Ltd.*, 229 B.R. 750, 752 (E.D. Wis. 1998).

Jackson National Life Insurance Company, a major creditor of Bucyrus that had purchased \$60 million in senior Bucyrus notes, subsequently filed a motion seeking to have the court disgorge Milbank's fees. *See United States of America v. John G. Gellene*, 24 F. Supp. 2d 916, 920, n.2 (E.D. Wis. 1998). John Gellene, the Milbank partner responsible for the Bucyrus bankruptcy case, failed to tell his fellow partners about the motion until confronted by another partner at the firm after the time for filing a response to the motion had expired. *Id.* The firm is reported to have first learned of the motion when a reporter at *The Wall Street Journal* called another partner for a comment on the matter. John Gellene is reported to have stated at his criminal trial for perjury that he believed, at the time that he filed his disclosure documents, that Salovaara did not fit the definition of a "creditor" whose relationship needed to be disclosed, that the positions of Bucyrus and the South Street Funds were not adverse to one another, and that other partners at the firm failed to inform him of the extent of their work for Salovaara. *Milwaukee Journal Sentinel* (February 28, 1998).

Milbank ultimately disgorged \$1.9 million in fees that Bucyrus had paid for its bankruptcy services, and was sued by Bucyrus and Jackson National Life Insurance Company, in the amount of \$100 million, for malpractice allegedly arising from the dual representation. John Gellene was found guilty of two felony counts of making false material declarations under penalty of perjury and one felony count of knowingly using a document under oath that contained false material declarations and was sentenced in connection with the matter.

II. The Response: Formulating a Disclosure Checklist

The Granite Partners, Leslie Fay and Bucyrus decisions led a team of Dewey & LeBoeuf bankruptcy lawyers to devise a procedure, embodied in a disclosure checklist, that would assist the firm in determining the existence of actual and potential conflicts and help ensure appropriate disclosure to the bankruptcy court throughout the course of a fiduciary representation. The balance of this paper describes the procedures that were developed and set forth in that checklist.

A. Opening and Maintaining a Conflicts File

The disclosure checklist requires, as an initial matter, the opening of a conflicts file. This file would include copies of all of the documentation received by a lawyer designated specifically for the proposed representation as the disclosure lawyer. The documentation would include a copy of the conflicts report prepared from the firm's client/matter database, all correspondence concerning potential conflicts, written waivers and memoranda regarding conversations with partners in connection with clearing potential conflicts. The disclosure lawyer would have an ongoing responsibility to maintain the conflicts file, monitor the development of potential conflicts and provide ongoing information to the bankruptcy lawyer responsible for the fiduciary representation.

B. Identification of Names Input into the Firm Database

The checklist requires that the disclosure lawyer identify and input into the firm database the names of all significant entities known to be involved in the bankruptcy case to the best of the firm's knowledge. This list of names should be supplemented to the extent that entities are not known at the time of the initial input. Specifically, the checklist requires that the names of the following entities be provided to the persons responsible for maintaining the firm's client conflict database, including: (1) the names of the debtor, including trade names, former names and dba's; (2) the name of the trustee in the case of a trustee representation; (3) partnership and corporate relationships with the debtor including affiliate relationships; (4) parties with whom the debtor has a material non-bankruptcy specific dispute; (5) all creditors listed in the petition or otherwise identified; (6) all professionals involved in the case to the extent known; and (7) any other parties involved materially in the case to the extent known.

C. Publicly Held Companies

In respect to publicly held companies, the checklist requires that the disclosure lawyer circulate a memorandum to all partners, lawyers and other employees of the firm explaining that the firm is seeking to represent a fiduciary and directing that each partner or employee return the attached questionnaire if the partner or the employee has any relationship to the debtor, the directors, officers and principal shareholders of the debtor, the committee members, other parties known to be involved in the bankruptcy case or if the partner or employee owns any securities issued by the debtor.

D. The Conflicts Search

The checklist requires that the disclosure lawyer supervise the inputting of all entities into the conflicts system using a list of two-letter code descriptions developed in conjunction with the firm's conflicts department. When conducting the conflicts check, the disclosure lawyer or responsible partner is required to advise the conflicts department that the matter is a bankruptcy matter and to direct that all key entities, such as the debtor, its officers, directors and controlling shareholders, important creditors, committee members and key professionals be "flagged" with (1) the name of the partner responsible for the fiduciary retention and (2) an instruction that all partners seeking to open a matter involving any of these entities clear the matter with the "flagged" bankruptcy partner.

E. Reviewing The Conflicts Report, Clearing Conflicts and Preparing For Disclosure

1. Reviewing and Clearing Conflicts

The disclosure checklist requires that the disclosure lawyer collect and review all “hits” received from conflicts search (those entities appearing in the conflicts search to have had connections of any kind with the firm); contact the appropriate lawyers and prepare notes or memoranda with respect to actual or potential conflicts; and send individualized follow-up memoranda to firm practice groups or offices likely to have had contacts or connections with respect to the fiduciary representation. If there are actual or potential conflicts, the bankruptcy partner in charge of the fiduciary representation, together with another bankruptcy partner, is required to determine whether the representation can and should be undertaken even if each client consents. Moreover, the partner in charge of the fiduciary representation, or the disclosure lawyer, is required to cause the firm accounting department to calculate the percentage of revenue derived from clients with whom the firm has an ongoing client relationship and determine, to the extent possible, whether any “flagged” entities (parties participating in the bankruptcy whose names were entered into the conflicts database with a notation that the entity is involved in a bankruptcy and an instruction to contact the appropriate bankruptcy partner before accepting a new representation from that entity) are bank syndication participants or investment banker/underwriters with whom there may exist a lawyer-client relationship but who do not appear as clients in the firm’s client database.

2. Preparing The Initial Disclosure

The checklist requires that the declaration in support of the retention application describe each connection with interested parties, whether or not such connection was determined by the firm to be a conflict. The disclosure is required to include all relevant information of which the firm is aware, regardless of the extent to which it may appear to be trivial, attenuated or insignificant, including: potential conflicts of interest; the nature of the firm’s current or previous representation of any other party in the case; the percentage of the firm’s revenues for which each current representation accounts; the name of any party or professional involved in the case who is currently suing the firm; the name of any party in interest materially involved in the case with whom the firm has substantial business relationships or debtor-creditor relations (such as the firm’s principal lender(s) and landlord(s)); the names of any former firm lawyers involved in any way with any party; and the name of any trade association, committee, or other organization represented by firm of which the debtor is a member. The checklist requires that the lawyer preparing the declaration not rely upon boilerplate general disclosures, disclose any conflicts waivers obtained and any conflicts waivers requested but not obtained and disclose any limitations on the firm’s ability to perform anticipated work.

F. Ongoing Conflicts Monitoring and Supplemental Disclosure

The disclosure lawyer, as well as other lawyers and paralegals, are required to engage in ongoing monitoring of potential conflicts and to update all information input into the firm’s conflicts system on an ongoing basis so that the bankruptcy court can be provided with supplemental disclosure when appropriate. This ongoing process includes (1) monitoring email memoranda listing new employees hired by the firm, (b) obtaining resumes from the new employees and forwarding to them all disclosure memoranda and (c) following up with respect to potential and actual conflicts arising as a result of their former employment.

This article is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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8992 REV02 07-21-2010

G. Special Circumstances

With respect to so called “beauty contests”, the checklist requires that: where practicable, lawyers seek waivers in cases where the firm is not selected as counsel; prevent or minimize receipt of confidential information, including written confidential information; keep confidential any information obtained and screen participating lawyers, as appropriate, from other representations; and minimize any possibility that an attorney-client relationship is created based upon the presentation. With respect to firewalls and screening procedures, the checklist requires that such walls and screening procedures be in writing, copied to all relevant lawyers and staff and identify those persons and matters screened. The checklist provides that the firm should periodically check the efficacy of its firewalls and procedures.

III. Conclusion

The author of this paper and those members of the bankruptcy team that wrestled with disclosure issues and formulated the checklist and procedures set forth herein recognize that no system for ensuring adequate disclosure is foolproof. It is hoped, however, that this paper will be a springboard for discussions with other lawyers, the United States Trustees for the various regions and, ultimately, bankruptcy judges, in the formulation of a uniform guideline for disclosure in all fiduciary representations that will minimize the likelihood that lawyers and law firms will place themselves in the same type of jeopardy as was encountered by those that were the subject of this discussion.