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Dueling Allegiances? Ethical Issues for Estate Professionals Involving Former Clients, Concurrent Clients and Dual Representations

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Dueling Allegiances? Ethical issues for estate professionals involving former clients, concurrent clients, and dual representations.

Everyone knows that estate professionals must be disinterested and able to represent the debtor free of conflicts. But what happens when the professional represents a related nondebtor party — for example, the private-equity sponsor or the sole member/shareholder? What if the professional has relationships with others in the case? The professional may bring significant experience and value to the table, some being derived from its prior representation of the debtor, creditors, or others involved in the case. When do these considerations outweigh the interests of the estate and the integrity of the system? Is disclosure of the potential conflicts and relationships enough? This panel will explore these and related issues to help guide professionals and judges alike.

I. Introduction

- Overview of bankruptcy law and the importance of legal representation.
- General rule that individuals and entities should be able to retain counsel of their choice.
- Brief mention of key issues with representation: conflicts of interest, dual representation, and the role of independent directors.

II. Legal Standards Governing Representation

A. Key Rules of Professional Conduct

1. Rule 1.7: Conflicts of Interest—Current Clients

- Addresses concurrent representations: "Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest." MRPC 1.7(a).
- Generally, the rule prohibits representation of clients with conflicting interests unless informed consent is obtained and other conditions met.

2. Rule 1.8: Conflict of Interest—Current Clients: Specific Rules

- Addresses business transactions with clients including (among others): potential conflicts; using information to the disadvantage of other client; prohibits gifts and certain compensation; and governs settlement when representing multiple clients.
- The rule also provides, "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." MRPC 1.8(k).

3. Rule 1.9: Duties to Former Clients

- Generally, the rule governs when former representations create conflicts: "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." MRPC 1.9(a).

- Restricts attorneys from representing new clients with interests adverse to former clients without consent.
- Protects confidential information of former clients.

4. Rule 1.13: Organization as Client

- Governs disclosure obligations for potential misconduct an organizational client.
- Rule 1.13 also provides,

  A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

  MRPC 1.13(g).

5. Rule 1.18: Duties to Prospective Client

- What happens when a professional is interviewed by one party (perhaps the debtor) and then is hired by another party (say the committee)?
- Rule 1.18 provides,

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

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

  MRPC 1.18.

6. Rule 3.3: Candor to the Tribunal

- Disclosures in a bankruptcy case may implicate Rule 3.3, which provides:

  A lawyer shall not knowingly:

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

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

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

  MRPC 3.3.

B. Bankruptcy Code Provisions

1. Section 327: Employment of Professional Persons

- Generally, the section provides, "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." 11 U.S.C. § 327.
- Governs the retention of attorneys and other professionals in bankruptcy cases.
- Requires a showing of disinterest and lack of conflicts for retention.

2. Section 101(14): Definition of Disinterested Person

- Defines who qualifies as a "disinterested person" and the implications for legal representation.
- "The term 'disinterested person' means a person that—(A) is not a creditor, an equity security holder, or an insider; (B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and (C) 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." 11 U.S.C. § 101(14).
- Underscores the importance of independence in representing the debtor or creditors.

III. Types of Conflicts and Issues

A. Concurrent Clients; Potential for Dual Representations

- Challenges in representing multiple clients in the same or related bankruptcy cases; when is it possible and what is required?
- Often occurs in representing multiple parties in interest (non-estate entities such as creditors) in bankruptcy case; largely governed by applicable nonbankruptcy law.
- Can arise with estate professional, seeking to continue representation of, for example, debtor and nondebtor entities.
- Risks of divided loyalty and the necessity of informed consent; importance of timing and extent of disclosures for estate professionals.
- Do advance waivers work? Are they permitted under applicable nonbankruptcy law?

B. Former Clients

- Must evaluate whether current or former representations cause potential or actual conflicts of interest and issues regarding disinterestedness for estate professionals.

- Can arise for professionals seeking to represent the debtor, the trustee, or the committee: who typically raises and how best to address?
- Importance of timing and extent of disclosures for estate professionals.
- Obligations to former clients; confidentiality and other obligations imposed by professional rules apply in the context of bankruptcy.
- Strategies to navigate potential conflicts.

C. Role of Independent Directors

- Importance of independent directors in managing conflicts in bankruptcy cases.
- How independent directors assist with governance and management issues and potential conflicts with former management.
- Issues that can arise out of independent directors' relationships with parties involved in bankruptcy case and how to mitigate potential conflicts of interest.

IV. Case and Issue Summaries

A. Invitae

- Court granted retention application for debtor's counsel, which also represented secured noteholder.
- The Bankruptcy Court explained:

Third Circuit case law establishes that:

> (1) Section 327(a), as well as § 327(c), imposes a per se disqualification as trustee's counsel of any attorney who has an actual conflict of interest; (2) the district court may within its discretion—pursuant to § 327(a) and consistent with § 327(c)—disqualify an attorney who has a potential conflict of interest and (3) the district court may not disqualify an attorney on the appearance of conflict alone.

In re Marvel Ent. Grp., Inc., 140 F.3d 463, 476 (3d Cir. 1998); *see also In re Boy Scouts of Am.*, 35 F.4th at 158 n.5 (collecting cases and explaining that § 327(a) "only allows disqualifications for adverse interests that exist at the time of retention").

> While acknowledging that K&E is representing both the Debtors and Deerfield concurrently, the Court finds that such concurrent representation does not create a per se conflict that prohibits retention. Indeed, to hold otherwise would ignore binding case law and § 327(c), which explicitly states that "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 an actual conflict of interest." 11 U.S.C. § 327(c). For reasons discussed below, the Court concludes that no actual conflict exists, and that

> K&E is "disinterested" as that term is defined in the Code, *see* 11 U.S.C. § 101(14).

In re Invitae Corp., No. 24-11362 (MBK), 2024 WL 2230069, at *2 (Bankr. D.N.J. May 16, 2024).

B. Enviva

- Court denied retention application for debtor's counsel.
- Multiple relationships, including representation of members of ad hoc committee, equity holders, and directors and officers in unrelated matters.
- The Bankruptcy Court acknowledged disclosure but found not enough:

> The Court understands that in complex cases such as this one, Rule 2014(a) disclosures are a difficult, time-consuming task. To be clear, all applicants for professional employment have a continuing duty of disclosure of any connections. The Court finds that V&E was not deficient in its disclosure obligations in this case. It appears that all V&E's connections were disclosed in advance of the hearing on its Employment Application on May 9th. V&E acknowledged its belated disclosure of Oaktree as a client, but V&E described Oaktree as a "late entrant" into the Debtors' debt structure, and the Court accepts that explanation. This is not a case where an undisclosed conflict is discovered deep into the case.

In re Enviva Inc., No. 24-10453-BFK, 2024 WL 2795274, at *6 (Bankr. E.D. Va. May 30, 2024), reconsideration denied, No. 24-10453-BFK, 2024 WL 3285781 (Bankr. E.D. Va. July 2, 2024) (footnotes omitted).

C. Cinch

- An entity affiliated with chapter 7 debtor filed a motion to disqualify the trustee's counsel.
- In denying the motion to disqualify, the Bankruptcy Court observed,

> In its Motion to Disqualify, CES contends that Special Counsel's application and supplement omit details sufficient for the Court to determine their level of disinterestedness and qualifications under 11 U.S.C. § 327(a). CES argues this requires their disqualification in representing Trustee. (ECF No. 141 at 8). CES argues that Special Counsel's Disclosures were inadequate under Rule 2014 and § 327 considering the disclosures omit the State Court Litigation and McGuffin's alleged membership interest in CES. Watts further argues that, as new counsel to CES, he acted as expeditiously as possible to file this Motion to Disqualify.
>
> To reiterate, the alleged conflict here stems from the dual representation by BBLF in which the firm serves: (1) as Special Counsel to Trustee in prosecuting claims for damages against "insiders" and "affiliates" in the bankruptcy case, (2) while also representing Mary Kay McGuffin, a creditor with a $16,500,000 proof of claim filed

in the bankruptcy case, in state court litigation related to her equity interest in CES and failure to receive profits from CES's operations. (ECF No. 141 at 2); (ECF No. 141, Ex. A). CES has since objected to McGuffin's proof of claim, countering that it is an alleged equity interest instead. (ECF No. 139). J&O has also been retained by the Trustee as Special Counsel and is also serving as McGuffin's counsel in the bankruptcy case. (ECF No. 141 at 2). In CES's view, "BBLF's and J&O's failure to disclose McGuffin's alleged equity ownership in the Debtor is sufficient on its own to justify disqualification."

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"A party seeking disqualification of an attorney based on the attorney's former representation of the party in a substantially related matter must show disqualification to be appropriate through a specific delineation of the 'subject matter, issues, and causes of action' common to both representation." *Islander E. Rental Program v. Ferguson*, 917 F. Supp. 504, 510 (S.D. Tex. 1996) (quoting *American Airlines*, 972 F.2d at 614). "Once it is established that the prior matters are substantially related to the present case, 'the court will irrebuttably presume that relevant confidential information was disclosed during the former period of representation.' " *Azad v. Nationwide Prop. & Cas. Ins. Co.*, No. 3:19-CV-312-E (BH), 2019 WL 10888765, at *3 (N.D. Tex. Nov. 12, 2019). The Fifth Circuit has a high standard for pleading substantial relationships, requiring that Debtor argue "with requisite specificity." *See McGurgan*, 2024 WL 2031774, at *3 (citing *Duncan v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 646 F.2d 1020, 1029 (5th Cir. 1981)) ("Merely pointing to a superficial resemblance between the present and prior representations will not substitute for the careful comparison demanded by our cases."). Requisite specificity means that there is sufficient detail for the Court to "engage in a 'painstaking analysis of the facts.' " *Id.* The Court cannot consider "general assertions that lack the specificity to allow this Court to properly evaluate whether there is a substantial relationship between the subject matter of the present and former representations." *Id.* Specificity is plead through "tender[ing] affidavits that provide the necessary detail required by the Fifth Circuit." *Id.*

In its Motion to Disqualify, CES argues that Special Counsel is precluded from representing Trustee because the State Court Litigation, in which McGuffin is suing to establish a membership interest, and Trustee's litigation, in which Trustee is investigating insider causes of action, "aris[e] from the same facts." (ECF No. 141 at 2). Debtor's briefing and oral argument[9] largely focused on the omission in Special Counsel's application that McGuffin was being represented in state court and lack of explanation as to "how [Special Counsel] can independently pursue causes of action for damages against insiders without bias and simultaneously represent McGuffin." (ECF No. 141 at 13).

While the Court, following the Fifth Circuit's lead, is sympathetic to any perceived conflicts of interest, the Court finds that allegations of a substantial relationship are not plead with sufficient specificity. The mere fact that the causes of action "arise from the same facts" is insufficient for this Court to make the "painstaking analysis" required of it to find that the substantial relationship test is satisfied. It is not ultimately the role of the Court to read between the lines, in light of staunch Fifth Circuit precedent requiring

> specificity in pleading substantial relationships. The Court now turns to whether Debtor waived its right to disqualify Special Counsel's representation of Trustee.
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> ***
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> Even if waiver did not occur, on balance, the "costs and benefits of disqualifying [Special Counsel] disfavor disqualification." *One World Foods, Inc. v. Stubb's Austin Rest. Co. LC*, No. A-15-CA-1071-SS, 2016 WL 6242121, at *8 (W.D. Tex. Oct. 25, 2016). The Court appreciates CES's concern of a potential conflict of interest, but timeline is not everything. Courts also consider whether disqualification "would impose significant costs in time and money" and whether disqualification "would likely cause significant delays in the case." *Id.* The Fifth Circuit clarified in *In re Dresser Industries, Inc.*[11] that in the context of concurrent representation, this Court must consider whether the conflict has "(1) the appearance of impropriety in general, or (2) a possibility that a specific impropriety will occur, and (3) the likelihood of public suspicion from the impropriety outweighs any social interests which will be served by the lawyer's continued participation in the case." *In re Dresser Indus., Inc.*, 972 F.2d 540, 544 (5th Cir. 1992). Here, no evidence was presented of impropriety or that there is a strong possibility that impropriety will occur. This leaves the Court to consider and give more weight to the public interest consideration. The public interest presents a strong argument in favor of maintaining Special Counsel.

In re Cinch Wireline Servs., LLC, No. 23-51742-CAG, 2024 WL 4161463, at *4, *7–*9 (Bankr. W.D. Tex. Sept. 11, 2024) (footnotes omitted).

D. MMA Law Firm

- Proposed counsel to the committee had been interviewed by the debtor prior to the filing of the bankruptcy case.
- The Bankruptcy Court summarized its position as follows:

> This Memorandum Opinion examines the nuanced differences between what may give rise to disciplinary action from the state bar of Texas as opposed to what standards of ethical conduct are mandated of attorneys appearing in federal courts in the Fifth Circuit and the perils of taking on representation adverse to a former prospective client. Here, MMA Law Firm, PLLC contends that Okin Adams Bartlett & Curry, LLP should be disqualified because it holds confidential information about MMA Law Firm, PLLC, who was a prospective client of Okin Adams Bartlett & Curry, LLP, that could now be used to the detriment of MMA Law Firm, PLLC, in this case.
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> For all of the reasons discussed herein, MMA Law Firm, PLLC's motion to disqualify is granted. Okin Adams Bartlett Curry, LLP is disqualified from representing the official committee of unsecured creditors in this case, thus the pending application to employ Okin Adams Bartlett Curry, LLP is summarily denied.

In re MMA L. Firm, PLLC, 660 B.R. 128, 131 (Bankr. S.D. Tex. 2024).

E. Easterday

- Two related debtors were represented by the same law firm in their respective chapter 11 cases. At the time of the retention application, no actual conflicts existed between the two debtors. Primary question was whether proposed plans of reorganization that adjusted debtors' liabilities crossed the line from potential conflict to actual conflict, warranting a disgorgement of fees.

- The Bankruptcy Court concluded:

> At bottom, PSZJ's representation of both Ranches and Farms in the plan process was part of complex negotiation among numerous represented stakeholders that eventually produced a holistic settlement of intercompany and other disputes. This activity does not constitute an actual conflict triggering Bankruptcy Code section 328(c). To the contrary, the record makes clear that PSZJ "determined in good faith and as an exercise of [their] professional judgment that the course complies with the Bankruptcy Code and serves the best interests of the estate," consistent with the firm's professional "responsibility ... to help lead the estate on a just, speedy, inexpensive and lawful path out of bankruptcy."[55] Moreover, because the Farms estate ultimately and obviously benefitted in tangible ways from PSZJ's work regarding the Offending Plans, the related professional fees are compensable under Bankruptcy Code section 330(a) despite the fact that the court confirmed neither plan.
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> ***
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> Setting aside the preceding analysis, for the sake of completeness the court has considered whether application of Bankruptcy Code section 328(c) justifies a reduction of PSZJ's compensation. After weighing the totality of the record, the court in an exercise of its discretion under section 328(c) finds and concludes that no penalty would be warranted for two reasons.

In re Easterday Ranches, Inc., 647 B.R. 236, 254 (Bankr. E.D. Wash. 2022).

F. Issues in FTX

- The issues in this case were summarized as follows:

> A U.S. judge on Friday signed off on FTX's choice of legal advisers to navigate its bankruptcy, after the collapsed crypto exchange told the court it had reached an agreement that resolved the U.S. Department of Justice's concerns about potential conflicts of interest.
>
> The U.S. Trustee, the Justice Department's bankruptcy watchdog, and two of FTX's creditors had asked U.S. Bankruptcy Judge John Dorsey in Wilmington, Delaware not to approve FTX hiring Sullivan & Cromwell, arguing the New York law firm had not disclosed sufficient information about its past ties to FTX.
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> These ties, they said, include the fact that FTX's U.S. general counsel, Ryne Miller, is a former partner at the firm.

> The U.S. Trustee and a Sullivan & Cromwell lawyer representing FTX told Dorsey at a hearing on Friday that the firm and the exchange provided the Justice Department additional disclosures about the firm's pre-bankruptcy work, which satisfied the department's concerns.
>
> Dorsey said the objectors had not shown there was an active conflict of interest between FTX and the firm, and to the extent that conflicts could arise there were procedures in place to deal with them.

Reuters, *FTX Wins Court Approval to Hire Bankruptcy Lawyers Amid Conflicts Concerns*, 72 No. 6 Bankr. Ct. Dec. News 12 (Feb. 16, 2023); *see also* Dominick V. Manetta, *"No Conflict Here Counsel, Scout's Honor": The Third Circuit Sets the Standard for Reviewing Retention of Counsel Under 11 U.S.C. § 327 in in Re Boy Scouts of America*, 68 Vill. L. Rev. 97 (2023).

G. Example of Consequences of Non-Disclosure

- The Bankruptcy Court required disgorgement of attorneys' fees to address the attorney's failure to timely disclose payments to insider:

> The Court is presented with the undesirable circumstance of being asked to approve the fees of an attorney who put his personal pecuniary interests ahead of his fiduciary duties and professional obligations, which resulted in a breach of those duties and obligations. Before the Court is the Court's *Amended Order to Show Cause as to Why This Court Should Not Issue Sanctions Against Kevin Kerveng Tung, P.C. and Kevin K. Tung, Esq., in His Individual Capacity, for Potential Violations of the New Jersey Rules of Professional Conduct, the United States Code, and the Federal Rules of Bankruptcy Procedure* (the "Second OSC") that the Court issued because of questions arising from the *First and Final Fee Application of Kevin Kerveng Tung, P.C. for Professional [sic] Services Rendered and Reimbursement of Expenses Incurred and Posted as Counsel for 38-36 Greenville Ave LLC. [sic] During the Period from February 9, 2016 to October 10, 2017* (the "Fee Application") submitted by Kevin Kerveng Tung, P.C. ("KKT"), the law firm of record for debtor 38-36 Greenville Ave L.L.C. (the "Debtor").[2] Importantly, the Court's questions stem from the Fee Application's indication that KKT intends to pay $19,400 of its fees to the Debtor's principal, Lingyan Quan (the "Debtor's Principal") on account of compensation the Debtor's Principal paid to KKT post-petition (the "Undisclosed Payments").[3] The Fee Application provides no further information about the payments nor why $19,400 is due to the Debtor's Principal. The Court held a hearing to resolve these questions. The answers provided were wholly unsatisfactory leaving the Court with only one choice—complete denial of KKT's fees and disgorgement of any fees received in this case on behalf of the Debtor and a referral of this matter to the Chief Judge of the District Court.

In re 38-36 Greenville Ave L.L.C., No. 16-15598 (SLM), 2020 WL 1680724, at *1 (Bankr. D.N.J. Apr. 6, 2020), *aff'd sub nom. 38-36 Greenville LLC v. Forman*, No. CV 20-3563,

2021 WL 8087151 (D.N.J. June 9, 2021), *aff'd sub nom. In re 38-36 Greenville Ave LLC*, No. 21-2164, 2022 WL 1153123 (3d Cir. Apr. 19, 2022) (footnotes omitted).

- In affirming the lower courts' decisions, the Third Circuit explained:

  > KKT next asserts that, even if the Bankruptcy Court possessed authority to order disgorgement, it abused its discretion by entering the Fee Order, which ordered disgorgement and denied KKT's Fee Application. The word "chutzpah" comes to mind. KKT's repeated violations of the Bankruptcy Rules and the Code, along with counsel's lack of candor, more than justified entry of the Fee Order. *See In re Bressman*, 327 F.3d 229, 240 (3d Cir. 2003) (indicating that "a bankruptcy court may order the disgorgement of fees received by an attorney when he or she has ignored reporting and court approval duties imposed by the Code"); *In re Downs*, 103 F.3d 472, 479 (6th Cir. 1996) (holding that the bankruptcy court has inherent authority to "deny all compensation to an attorney who exhibits a willful disregard of his fiduciary obligations to fully disclose the nature and circumstances of his fee arrangement").
  >
  > We reiterate that the Code and associated Rules impose a rigorous structure of oversight on a debtor, its professionals, and the estate. At the heart of that structure is a baseline presumption – and an expectation – of disclosure and candor. *See, e.g.*, Fed. R. Bankr. P. 2014(a) (requiring counsel to disclose "any proposed arrangement for compensation"); Fed. R. Bankr. P. 2016(b) (requiring that compensation be disclosed "within 14 days after any payment or agreement not previously disclosed"); 11 U.S.C. § 329(a) (requiring comprehensive disclosure of payments in connection with bankruptcy); *id.* § 330(a) (requiring counsel to file fee applications when seeking payment for services rendered). KKT flouted those obligations, and we will not disturb the Bankruptcy Court's well-justified response.
  >
  > Lastly, though it is hardly worthy of response, we dispose of KKT's argument that a photograph of the Bankruptcy Judge and the Chapter 7 Trustee, taken at a New Jersey Bankruptcy Lawyers Foundation event, somehow evidences judicial bias. It does not, and the District Court did not abuse its discretion by striking KKT's supplemental letter as "wholly irrelevant and without merit." (App. at 19.) *See Meditz v. City of Newark*, 658 F.3d 364, 367 n.1 (3d Cir. 2011) ("We review the District Court's decision denying the motion to strike for an abuse of discretion.").

In re 38-36 Greenville Ave LLC, No. 21-2164, 2022 WL 1153123, at *4–5 (3d Cir. Apr. 19, 2022), *cert. denied sub nom. Kevin Kerveng Tung, P.C. v. Forman*, 143 S. Ct. 118, 214 L. Ed. 2d 31 (2022); *see also In re Mercury*, 280 B.R. 35 (Bankr. S.D.N.Y. 2002), *subsequently aff'd,* 122 F. App'x 528 (2d Cir. 2004) (explaining "by failing to disclose its conflict of interest, and by breaching its contractual, ethical, and legal obligations to debtors, firm forfeited its right to compensation and reimbursement of expenses").

H. Empirical Study of "Bankruptcy Directors"

- Recent empirical study suggests some issues with the use of independent directors in bankruptcy cases. Do these results translate to what judges and practitioners see on the ground in their cases? The researchers explain,

> This Article is the first empirical study of these directors. While a voluminous literature has considered the governance of Chapter 11 firms, this Article breaks new ground in shining a light on an important change in the way these firms make decisions in bankruptcy and resolve conflicts with creditors.[12] It does so by analyzing a hand-collected sample of all large firms that filed for Chapter 11 between 2004 and 2019 that disclosed the identity of their directors to the bankruptcy court. To our knowledge, it is the largest sample of boards of directors of Chapter 11 firms yet studied.
>
> We find that the percentage of firms in Chapter 11 proceedings claiming to have an independent director increased from 3.7% in 2004 to 48.3% in 2019. Over 60% of the firms that appointed bankruptcy directors had a controlling shareholder and about half were under the control of private equity funds.
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> After controlling for firm and bankruptcy characteristics, we find that the recovery rate for unsecured creditors, whose claims are typically most at risk in bankruptcy, is on average 20% lower in the presence of bankruptcy directors. We cannot rule out the possibility that the firms appointing bankruptcy directors are more insolvent and that this explains their negative association with creditor recoveries. Still, this finding at least shifts the burden of proof to those claiming that bankruptcy directors improve the governance of distressed companies to present evidence supporting their view in this emerging debate.
>
> We also examine a mechanism through which bankruptcy directors may reduce creditor recoveries. In about half of the cases, these directors investigate claims against insiders, negotiate a quick settlement, and argue that the court should approve it to save the company and the jobs of its employees. We supplement these statistics with two in-depth studies of cases in which bankruptcy directors defused creditor claims against controlling shareholders: Neiman Marcus and Payless Holdings.
>
> Finally, we consider possible sources of pro-shareholder bias among bankruptcy directors. Shareholders usually appoint bankruptcy directors without consulting creditors. These directors may therefore prefer to facilitate a graceful exit for the shareholders. Moreover, bankruptcy directorships are short-term positions, and the world of corporate bankruptcy is small, with private equity sponsors and a handful of law firms generating most of the demand. Bankruptcy directors depend on this clientele for future engagements and may exhibit what we call "auditioning bias."
>
> In our data, we observe several individuals appointed to these directorships repeatedly. These "super-repeaters" had a median of 13 directorships and about 44% of them were in companies that went into bankruptcy when they served on the board or up to a year before their appointment. Our data also show that super-repeaters have strong ties to two leading bankruptcy law

> firms. Putting these pieces together, our data reveal an ecosystem of a small number of individuals who specialize in sitting on the boards of companies that are going into or emerging from bankruptcy, often with private equity controllers and the same law firms.
>
> These findings support the claim that bankruptcy directors are a new weapon in the private equity playbook. In effect, bankruptcy directors assist with shielding self-dealing transactions from judicial intervention. Private equity sponsors know that if the portfolio firm fails, they could appoint bankruptcy directors to handle creditor claims, file for bankruptcy, and force the creditors to accept a cheap settlement. Importantly, the ease of handling self-dealing claims in the bankruptcy court may fuel more aggressive self-dealing in the future.

Jared A. Ellias et. al., *The Rise of Bankruptcy Directors*, 95 S. Cal. L. Rev. 1083, 1087–89 (2022) (footnotes omitted).

- For a response to Prof. Ellias' study, see Howard Brod Brownstein & Kenneth A. Rosen, *Corporate Governance and the Bankruptcy Code*, Am. Bankr. Inst. J., March 2022, at 20, 21, observing (among other things):

  > Turning back to the proposals of Prof. Ellias and his colleagues to amend the Bankruptcy Code to require creditor and/or court approval of appointments to a debtor's board, we respectfully disagree. We see the authors' point that these repeat appointments may raise concerns about bias and independence, and we believe that all of us in the bankruptcy community agree that we need rules and practices that result in as little doubt as possible concerning the integrity of the process and the fairness of the result. Bankruptcy, by its nature, involves the impairment of pre-petition interests and compromise, so we all benefit from there being as little "noise" as possible about the reliability and ethical strength of the processes followed to reach a conclusion. Everyone involved in the bankruptcy process has a stake in keeping it free of corruption and undue influence, and the necessity for the independence of board members should be viewed in that context.
  >
  > That being said, we believe that it is serious "overkill" to start requiring creditor or court approval for board changes of debtors. We believe that parties in a bankruptcy proceeding already have standing to object to a debtor's actions on the basis of applicable state corporate law-- or any applicable federal or other regulatory scheme affecting corporate governance-- allegedly not having been followed. This includes instances when the independence of a debtor's board members--where such independence is required-- may be in doubt. That is a legitimate subject of inquiry that should be brought before the court.
  >
  > However, in order to enable parties to effectively exercise their right to bring up this issue (if indeed such an issue may exist), we agree that disclosure should be required about any relationships among the debtor's board directors and others involved in the case, both parties and professionals. Pursuant to § 327, professionals in a case are

already required to disclose "connections" to other parties and professionals, so that all parties and the court can be satisfied regarding their lack of any bias that might result therefrom. This concept of "connections" intentionally transcends relationships that might give rise to a requirement for a waiver under state law, *e.g.*, for a law firm that may represent both parties in a transaction. While a debtor's board directors are not bankruptcy professionals--they may be so in their "day job," but that is not their role in a bankruptcy case where they serve on the debtor's board--the concept of "connections" is appropriate here, since it is precisely those types of relationships that might be at issue.

Note that it is not our intention to prevent law firms from repeatedly calling upon prospective board members who have previously served in that role, whose performance and degree of professionalism they know well, and who are what they feel the debtor needs in this circumstance. Indeed, it is considered a "best practice" in nonbankruptcy corporate governance to regularly review board composition in light of the company's current and expected needs, and to make appropriate additions or changes to the board. Therefore, a company in or approaching bankruptcy likely needs a "refresh" of its board composition, and it may be difficult to find prospective directors who are willing to serve in a challenging board situation such as a bankruptcy proceeding, and who are knowledgeable about bankruptcy processes. Therefore, the phenomenon of repeat directors and leading debtor law firms introducing them is not itself a problem, there just needs to be more disclosure so that any potential issues can be surfaced and dealt with individually. Law firms introducing repeat directors should anticipate questions and provide meaningful disclosure up front to help head off any unwarranted inquiry and delay.

I. Other Select Commentary

- For an interesting discussion of views from practice, the bench, and academia, see Douglas Baird, Honorable Judith Fitzgerald & Marc Kieselstein, *Conflicts of Interest & Other Ethical Issues*, 1 DePaul Bus. & Com. L.J. 557 (2003).
- For a judge's perspective on the issues, see Arthur J. Gonzalez, *Conflicts of Interest and Other Ethical Issues Facing Bankruptcy Lawyers: Is Disinterestedness Necessary to Preserve the Integrity of the Bankruptcy System?,* 28 Hofstra L. Rev. 67, 84 (1999) (footnotes omitted), noting (among other things):

  Both a state's ethical requirements and § 327 apply in each bankruptcy case. It seems to me that when you examine the concerns of the New York Code and § 327 of the Bankruptcy Code the ethical issues are the same. What differs in bankruptcy though, is that these issues must be viewed in a much broader context; that being the interests of the estate and each class of creditors and equity holders. The issues of waiver and consent are far more difficult to address and in fact may not even apply in certain circumstances.

V. Key Takeaways

- Diligence (before and during representation); thoughtful review; and timely disclosures.
- Highlight any potential conflict or representation issues for court and parties; disclosure alone may not always cure the issue, but it will protect the parties and professionals involved.
- Remember key objectives of professionalism in bankruptcy: to, among other things, provide effective representation for all parties while adhering to ethical standards and legal requirements to maintain the integrity of the bankruptcy process.

Faculty

Steven N. Berger is a founding shareholder at Engelman Berger, P.C. in Phoenix and focuses his practice on resolution of commercial and debtor/creditor disputes and restructurings. He has represented debtors, creditors, creditors' committees, trustees, examiners, lessors and asset-purchasers, and he has acted as a trustee and examiner in a variety of business bankruptcy and reorganization cases during his 40 years in practice. Mr. Berger draws on that experience in assisting parties to reach settlements in his practice as a private mediator for all types of commercial disputes. He completed the course known as "Mediating the Litigated Case" from the Straus Institute at Pepperdine University. Mr. Berger started his legal career clerking for Hon. Thomas Tang of the Ninth Circuit Court of Appeals from 1984-85. He practiced at two of Arizona's largest firms before co-founding Engelman Berger in 1999. Mr. Berger has been an active member and held numerous leadership positions in the Bankruptcy Section of the State Bar of Arizona, planned bankruptcy CLE programs for several Bar Conventions, and served as a member and then chair of the Continuing Legal Education Committee of the State Bar of Arizona. He also was a founding member, vice president and program chair for the Arizona Bankruptcy American Inn of Court, and served as a lawyer representative to the Ninth Circuit from the District of Arizona. In March 2013, Mr. Berger was inducted as a Fellow into the American College of Bankruptcy. He is an active participant in various college boards, committees and projects. Mr. Berger received his B.A. in finance from Arizona State University in 1980 and his J.D. with highest distinction in 1984 from the University of Arizona, where he was an articles editor for the *Arizona Law Review*.

Laura S. Bouyea, CPA is a partner with Venable LLP and is co-leader of its Bankruptcy & Creditors' Rights Group in Baltimore. She represents debtors, secured and unsecured creditors, creditors' committees, bankruptcy trustees, liquidating agents, and other parties-in-interest in bankruptcy cases and related matters, including pre-bankruptcy counseling and planning, cash-collateral use, debtor-in-possession financing, automatic stay litigation, asset sales, plan litigation, fraudulent conveyance litigation, claim disputes, and claim administration. She also represents lenders, including special servicers of commercial mortgage-backed securities, in all aspects of the creditor/distressed debtor relationship, including loan modifications, foreclosure sales, receivership actions and sales, guaranty claims and lender-liability actions. Ms. Bouyea has represented clients in a variety of sectors and industries, including real estate, retail, government, health care and manufacturing. She also has experience in distressed real estate and bankruptcy matters and serves as the chairperson of the Workouts, Foreclosure and Bankruptcy Committee of the American Bar Association's Real Property Trust and Estates Section. Ms. Bouyea has represented lenders secured by real estate in bankruptcies of all sizes and levels of complexity, has served as lead counsel in hundreds of receiverships and foreclosures across the country of commercial properties of all types, obtained judgments on guaranties of commercial real estate loans, and defended lenders secured by real estate in lender-liability actions. Prior to law school, she earned her certified public accountant license and worked as an auditor for Arthur Andersen. Ms. Bouyea received her B.S./B.A. in accounting *cum laude* from the University of Richmond in 1999, and her J.D. with honors in 2003 from the University of Maryland School of Law.

Terri H. Didion is an Assistant U.S. Trustee for the Las Vegas Office in Region 17. She previously served as an Assistant U.S. Trustee in the Los Angeles and Riverside, Calif., Offices in Region 16,

and she has been a U.S. Trustee Appellate Coordinator for Regions 15 and 17, as well as a trial attorney for the U.S. Trustee in the Fresno and Santa Ana, Calif., and Honolulu Offices. Ms. Didion has conducted numerous bankruptcy trainings at the National Advocacy Center of the U.S. Department of Justice. For three years, she taught bankruptcy fraud courses for the FBI at Quantico. Prior to joining the U.S. Trustees Program, Ms. Didion clerked for Hon. Lynn Riddle (ret.) of the Central District of California and the late Hon. George M. Brody of the Southern District of California. She received her J.D. from San Joaquin College of Law.

Hon. Michelle M. Harner is a U.S. Bankruptcy Judge for the District of Maryland in Baltimore, appointed in 2017. Prior to her appointment to the bench, she was the Francis King Carey Professor of Law and the Director of the Business Law Program at the University of Maryland Francis King Carey School of Law, where she taught courses in bankruptcy and creditors' rights, business associations, business planning, corporate finance and the legal profession. Judge Harner lectured frequently during her academic career on various topics involving corporate governance, financially distressed entities, risk management and related legal issues. Her academic scholarship is widely published, with her publications appearing in, among others, the *Vanderbilt Law Review*, *Notre Dame Law Review*, *Washington University Law Review*, *Minnesota Law Review*, *Indiana Law Journal*, *Fordham Law Review* (reprinted in *Corporate Practice Commentator*), *Washington & Lee Law Review*, *William & Mary Law Review*, *University of Illinois Law Review*, *Arizona Law Review* (reprinted in *Corporate Practice Commentator*) and *Florida Law Review*. Judge Harner has served as the Associate Reporter to the Advisory Committee on the Federal Rules of Bankruptcy Procedure, the Reporter to the ABI Commission to Study the Reform of Chapter 11, and most recently chaired the Dodd-Frank Study Working Group for the Administrative Office of the U.S. Courts. She also served as the Robert M. Zinman ABI Resident Scholar for the fall of 2015. She most recently served as the chair of the Dodd-Frank Study Working Group for the Administrative Office of the U.S. Courts, and she is currently serving as a member of the Advisory Committee on the Federal Rules of Bankruptcy Procedure and an associate editor of the *American Bankruptcy Law Journal*. Judge Harner is an elected conferee of the National Bankruptcy Conference, an elected Fellow of the American College of Bankruptcy, and an elected member of the American Law Institute. She previously was in private practice in the business restructuring, insolvency, bankruptcy and related transactional fields, most recently as a partner at the Chicago office of the international law firm Jones Day. Judge Harner received her B.A. *cum laude* from Boston College in 1992 and her J.D. *summa cum laude* from The Ohio State University College of Law in 1995.

Chad J. Husnick is a partner in Kirkland & Ellis LLP's Restructuring Practice Group in Chicago. He represents debtors, creditors, equityholders and other stakeholders in all aspects of corporate liability management, restructuring, bankruptcy and insolvency proceedings. Mr. Husnick has represented clients in a variety of industries, including energy, retail, real estate, infrastructure, manufacturing, transportation and distribution, hospitality and gaming, automotive and printing. He regularly advises clients on corporate governance issues facing financially distressed companies, including liability-management strategies, fiduciary duties and executive compensation. Mr. Husnick has been recognized in the 2017-2424 editions of *Chambers USA, America's Leading Lawyers for Business*. He also was recognized in the 2022-24 editions of *The Legal 500 U.S.* Mr. Husnick was honored in 2018 as one of ABI's "40 Under 40." He is a conferee and member of the Executive Committee in the National Bankruptcy Conference, a Fellow in the American College of Bankruptcy, and a member of the International Insolvency Institute, ABI and Turnaround Management Association. In addition, he is a lecturer in the law at the University of Chicago Law School and a contributing author for *Collier on Bankruptcy*. Mr. Husnick

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