

# Nuts and Bolts of Corporate Bankruptcy 2014

## Basic Ethical Considerations in Bankruptcy

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# Introduction

- Employment of Trustees and Professionals
- Compensation of Trustees and Professionals
- Employment and Compensation of Professionals for Committees
- Compensation of Professionals Employed by Creditors and Others
- Prepetition Claims for Attorneys' Fees, Proofs of Claim, Objections

# Introduction

*(Cont'd)*

- Role of the Courts
- Role of the United States Trustee
- Sections 321 to 331 of the Bankruptcy Code
- Federal Rules of Bankruptcy Procedure
- Local Bankruptcy Rules
- Collective Proceedings that Raise Ethical Considerations Involving Multiple Parties
- ABI Ethics Report
- Disclose, Disclose, Disclose

# Appointment of Trustees

- Sec. 701 – appointment of an interim trustee by the U.S. Trustee in all chapter 7 liquidation cases promptly after the order for relief
- Sec. 702 – creditors holding at least 20% of undisputed, fixed claims may vote for a permanent trustee
- Sec. 703 -- appointment of a successor trustee if necessary

# Duties of Trustee

- Under sec. 704, duties of trustees include
  - Collection of property of the estate and reduction to money
  - Investigation of the financial affairs of the debtor
  - If a purpose would be served, examination of proofs of claim and objection to improper claims
  - If authorized, continuation of the business
  - Final report and accounting

# Appointment of Trustees

Section 1104(a) of the Bankruptcy Code

- For “cause,” including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause
- If such appointment is in the best interests of creditors, equity security holders, and other interests of the estate

# Chapter 11 Trustees (cont'd.)

- US Trustee must move for appointment of chapter 11 trustee if there are reasonable grounds to suspect that management engaged in dishonesty or criminal conduct
- Duties of chapter 11 trustee are similar to those of a chapter 7 trustee
- Court can and in some instances must appoint an examiner

# Eligibility to Serve as a Trustee

## Section 321

- An individual that is “competent to perform the duties of trustee”
- Person who has serve as examiner may not serve as trustee
- United States Trustee for the judicial district in which the case is pending

## Section 322

- To qualify, the person selected must file a bond with the court before seven days after such selection

# Grounds upon which prospective trustee may be disqualified

- Insider
- Prior representation of a party in interest
- Not “Disinterested”
- Examiner cannot be appointed as trustee

# Practical considerations

- Conversion from chapter 11 to chapter 7 will ordinarily require the appointment of a trustee as well as new professionals
- One trustee may be appointed for affiliated debtors but there may be conflicting interests that preclude a trustee from representing multiple debtors

# Employment of Professionals

- Sections 327 and 328 of the Bankruptcy Code
- Rule 2014 of the Federal Rules of Bankruptcy Procedure-Disclose Relationships, Connections
- Local Bankruptcy Rules and General Orders
- Applicable state statutes and rules governing ethics and professional responsibility

# Employment of Professionals

*(Cont'd)*

- **General Rule: Section 327(a)**
- With the court's approval, the trustee may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that
  1. do not hold or represent an interest adverse to the estate, and
  2. that are disinterested persons

# Employment of Professionals

*(Cont'd)*

- **The disinterested requirement**
  - Section 101(14): 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.

# Employment of Professionals

*(Cont'd)*

- **Exception: Section 327(b)**
  - Regularly employed in-house attorneys, accountants, or other professional persons on salary if necessary in the operation of the debtor's business.

# Employment of Professionals

*(Cont'd)*

- **Exception: Section 327(c)**
  - Employment by a creditor is not a disqualification, 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.

# Employment of Professionals

*(Cont'd)*

- **Exception: Section 327(d)**
  - The trustee acting as attorney or accountant for the estate if such authorization is in the best interest of the estate.
  - But court may allow compensation only for services as an attorney or accountant, not for services generally performed by a trustee without an attorney or accountant. Section 328(b).

# Employment of Professionals

*(Cont'd)*

- **Exception: Section 327(e)**
  - Employment for a specified special purpose, 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.

# Employment of Professionals

*(Cont'd)*

- **Section 328(a):**
  - With the court's approval, the trustee may employ a professional person on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis.
  - Application and Order should expressly refer to employment under section 328.
  - Provide justification for special treatment.

# Employment of Professionals

*(Cont'd)*

- **Section 328(a):**

The court may allow compensation different from the compensation provided under such terms and conditions after the conclusion of such employment, if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions.

# Employment of Professionals

*(Cont'd)*

- **Section 328(c):**
  - The court may deny compensation for services and reimbursement of expenses at any time if the 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.
  - Ongoing duty to check conflicts and “disinterestedness”

# Compensation of Trustees

## Section 326

- Formula based on “all moneys disbursed or turned over in the case by the trustee to parties in interest, excluding the debtor, but including holders of secured claims.”
- Compensation must be “reasonable.”

# Compensation of Professionals

- Sections 329, 330 and 331 of the Bankruptcy Code and Rules 2002, 2016 and 2017 of the Federal Rules of Bankruptcy Procedure

# Compensation of Professionals

*(Cont'd)*

- **Section 329(a): Review of Fees Paid Prior to the Bankruptcy Case**
  - Debtor's attorney must file a statement, whether or not seeking compensation, of the compensation paid or agreed to be paid during the one year prior to the bankruptcy filing, 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.

# Compensation of Professionals

*(Cont'd)*

- **Section 329(b)**

If such compensation exceeds the reasonable value of any such services, the court may order the return of any payments, to—

1. the estate, or
2. the entity that made the payment.

# Compensation of Professionals

(Cont'd)

- **Three reasons to get fee retainers prior to the commencement of the case**
  - Ensure payment of fees
  - Ensure professional is not a creditor and, therefore, not disinterested
  - Ensure that payment of prepetition fees is not an avoidable preferential transfer making professional not disinterested. *In re Pillowtex*, 304 F.3d 246 (3d Cir. 2002)
  - Retainers from third parties raise disinterested issues

# Compensation of Professionals

*(Cont'd)*

- **Section 330: Compensation of professionals**
- reasonable compensation for actual, necessary services rendered by the ... professional person, or attorney and by any paraprofessional person employed by any such person; and
- reimbursement for actual, necessary expenses.

# Compensation of Professionals

*(Cont'd)*

- **Section 330: Factors used in determining compensation and reimbursement of expenses**
  - A. the time spent;
  - B. the rates charged;
  - C. whether the services were necessary or beneficial;

# Compensation of Professionals

- Section 330 (*cont'd*)
  - D. whether performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed;
  - E. 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.

# Compensation of Professionals

*(Cont'd)*

- **Factors used in determining the amount of reasonable compensation**
  - Lodestar test: Reasonable number of hours multiplied by a reasonable hourly rate

# Compensation of Professionals

(Cont'd)

- Johnson factors from a nonbankruptcy case *Johnson v. Georgia Highway Express*, 488 F.2d 714, 717-19 (5th Cir. 1974)
  1. the time and labor expended;
  2. the novelty and difficulty of the questions raised;
  3. the skill required to properly perform the legal services rendered;
  4. the attorneys' opportunity costs in pressing the litigation;
  5. the customary fee for like work;
  6. the attorneys' expectation at the outset of the litigation;
  7. time limitations imposed by the client or the circumstances of the case;

# Compensation of Professionals

(Cont'd)

- Johnson factors from a nonbankruptcy case *Johnson v. Georgia Highway Express*, 488 F.2d 714, 717-19 (5th Cir. 1974) (cont'd)
  8. the amount in controversy and the results obtained;
  9. the experience, reputation, and ability of the attorneys;
  10. the undesirability of the case within the legal community;
  11. the nature and length of the professional relationship between the attorneys and the client; and
  12. attorneys' fees awarded in similar cases.

# Compensation of Professionals

(Cont'd)

- **Interim compensation prior to the end of the case—Section 331:**
  - Not more than once every 120 days
  - *Knudson case* allowed monthly payments for hardship to professionals
  - Same factors as section 330 in awarding compensation and expenses
  - Subject to final fee application and disgorgement

# Employment and Compensation of Committee Professionals

## Section 1102

- (a)(1) United States Trustee shall appoint unsecured creditors committee and may appoint additional committees of creditors or of equity security holders
- Party in interest may request appointment of additional committees, or that no committee be appointed in case of small business debtor (Section 1102(a)(2) and (3))
- Reconstitute committee (Section 1102(a)(4))

# Compensation of Professionals for Creditors

- Claim of oversecured creditor includes interest on such claim and reasonable fees, costs or charges provided for under the agreement (Sec. 506(b))
- Professionals for certain parties may receive compensation if allowed by court (e.g., DIP lenders)

# Disclosure of Multi-Party Representations

- Bankruptcy Rule 2014 requires extensive disclosure of all “connections” between the professional and the debtor, creditors, other parties in interest and their attorneys and accountants. Rule is strictly construed.

# Disclosure (contd.)

- Bankruptcy Rule 2019, amended December 1, 2011, requires disclosure of a “disclosable economic interest” on the part of “every group or committee that consists of or represents...multiple creditors or equity security holders that are (A) acting in concert to advance their common interests, and (B) not composed entirely of affiliates or insiders”

# Compensation of Professionals

- **Section 503(b)(3) for Creditors** : the actual, necessary expenses incurred by—
  - A. A creditor that files an involuntary bankruptcy petition;
  - B. A creditor that recovers, with the approval of the Bankruptcy Court, any property transferred or concealed by the debtor;
  - C. A creditor in connection with the prosecution of a criminal case relating to the business or property of the debtor;

# Compensation of Professionals

*(Cont'd)*

- **Section 503(b)(3) for Creditors** *(cont'd)*

D. A creditor, indenture trustee, an equity security holder, or an unofficial committee, in making a substantial contribution in a bankruptcy case. This is an important provision that we will discuss in more detail in a few minutes;

E. A custodian of the debtor's property that is required to turn the property over to the bankruptcy estate; and

F. A member of an Official Committee for expenses incurred in performing its duties as a member of the Committee.

# Compensation of Professionals

*(Cont'd)*

- **Section 503(b)(4) for Creditors' Professionals**
  - reasonable compensation for an attorney or an accountant of section 503(b)(3) entities, based on
    1. the time, the nature, the extent, and the value of such services, and
    2. the cost of comparable services other than in a bankruptcy case, and reimbursement for actual, necessary expenses incurred by such attorney or accountant

# Compensation of Professionals

*(Cont'd)*

- **Substantial Contribution Requirement**
  1. The Benefit to the Estate Test: Whether the contribution made by the claimant provided actual benefit to the estate.
  2. The Significance of the Contribution Test: Whether the contribution made by the claimant was meaningful in the context of the bankruptcy case.

# Compensation of Professionals

*(Cont'd)*

- **Substantial Contribution Requirement** *(cont'd)*
  3. The Direct and Demonstrable Benefit Test and the Tangible Benefit Test: Whether the claimant's contribution can actually be valued, or whether the benefit is merely indirect or speculative.
  4. The Intent or Purpose of the Creditor Test: Whether the creditor took action to further its own interest.

# Compensation of Professionals

*(Cont'd)*

- **Substantial Contribution Requirement** *(cont'd)*
  5. The Fostering Reorganization Test: Balance the benefits of the creditor's "opposition" against the costs of delay and disruption caused by that opposition.
  6. The "But For" Test: The strictest test, asks whether the debtor would have made it to the reorganization finish line "but for" the contribution made by the claimant. Generally, this will be very hard to prove.
- "Substantial contribution" is fact specific

# Prepetition Claims for Attorneys Fees-Miscellaneous

- Contract (Travelers v. Pacific Gas and Electric Co.)
- Section 502(b)(4) limits allowance of claim for services of an insider or attorney of the debtor to the reasonable value of such services

# Additional Issues

- Trustees control privileges
- Examiners
- Fee guidelines recently issued by the United States Trustee for “Mega cases”
- Unlawful practice of law in other jurisdictions
- Local counsel
- Conflicts counsel