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Amend Rule 2014(a) to Include a Rule of Reason or Safe Harbor Guidelines

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Rule 2014(a) provides, in part, that accompanying an application for the approval of employment of a professional on behalf of a bankruptcy estate pursuant to 11 U.S.C. §§327, 1103 or 1114 must be an affidavit by the professional that, *inter alia*, sets forth “all of the person’s connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants...” Fed. R. Bankr. P. 2014(a). This article suggests that the literal application of Rule 2014(a) requires a massive over-disclosure not possibly contemplated by the drafters of the Rule, and therefore, that the Rule should be amended to more precisely identify the types of “connections” deemed worthy of mandated disclosure. Alternatively, safe-harbor guidelines should be designated so that the failure to disclose immaterial connections that do not evidence or tend to evidence disqualifying conflicts of interest will not leave professionals at risk of serving *pro bono*.¹

The Rule

The disclosure requirements in Rule 2014(a) have been described as “very serious business.” *In re Sabre Intern. Inc.*, 289 B.R. 420, 426 (Bankr. N.D. Okla. 2003). Courts have applied a strict literal interpretation of the disclosure requirements,

“even if the results are sometimes harsh.” *In re Park-Helena Corp.*, 63 F.3d 877, 882 (9th Cir. 1995). “The disclosures in the Rule 2014 Affidavit must be explicit enough for the court and other parties to gauge whether the person to be employed is not disinterested or holds an adverse interest.” *In re Midway Industrial Contractors Inc.*, 272 B.R. 651, 662 (Bankr. N.D. Ill. 2001).



Arthur J. Spector

The seminal conflict of interest case in the bankruptcy context is *Woods v. City Nat’l. Bank & Trust Co.*, 312 U.S. 262 (1940), where the Supreme Court held that reasonable compensation to a professional serving in a bankruptcy case requires loyal, disinterested service and that when a professional serves two masters, compensation should be denied. In often quoted language, the Supreme Court stated:

[T]he incidence of a particular conflict of interest can seldom be measured with any degree of certainty. The bankruptcy court need not speculate as to whether the result of the action was to delay action where speed was essential, to close the record of past transactions where publicity and investigation were needed, to compromise claims by inattention where vigilant assertion was necessary, or otherwise to dilute the undivided loyalty owed to those whom the claimant purported to represent. Where an actual conflict of interest exists, no more need be shown in this type of case to support a denial of compensation.

Woods, 312 U.S. at 268. *See, also, Wolf v. Weinstein*, 372 U.S. 633, 641 (1963) (“a fiduciary may not receive compensation for services tainted by disloyalty or conflict of interest.”); *Mosser v. Darrow*, 341 U.S. 267, 271 (1951) (“Equity tolerates in bankruptcy trustees no interest adverse to the trust. This is not because such interests are always corrupt, but because they are always corrupting.”).

“[I]t is well established that conflict-of-interest rules are more strictly applied in the bankruptcy context than in other areas of the law, at least insofar as professionals retained by the estate are concerned. The strict approach maintains the integrity of the bankruptcy process...and assures counsel’s undivided loyalty to the client.” *In re Rusty Jones Inc.*, 134 B.R. 321, 346 (Bankr. N.D. Ill. 1991). *Accord, In re Plaza Hotel Corp.*, 111 B.R. 882, 883 (Bankr. E.D. Cal. 1990) (“Literal enforcement of [Rule 2014(a)] is required to assure its vitality in combating the evils against which it is aimed.”), *aff’d*, 123 B.R. 466 (B.A.P. 9th Cir. 1990). That conflicts of interest in the bankruptcy context are taken seriously, and rightly so, begs the question of whether disclosures that are required by a literal application of the unambiguous language set forth in Rule 2014(a), but that would not evidence or tend to evidence any disabling conflicts of interest, are appropriately required of professionals serving bankrupt estates. The balance of this article focuses on this issue.



Paul A. Avron

“Courts have recognized three broad categories of ‘connections’—financial, business and personal that must be disclosed pursuant to Rule 2014.” Bowles, C.R. “Chip” Jr., “Disclosing Connection and Relationships under Rule 2014,” 2001 *ABI Journal* LEXIS 72 (April 2001) (hereafter “Straight & Narrow”). In his thoughtful article, Mr. Bowles notes that “courts are increasingly requiring” professionals to disclose personal connections, but that the “full range” of these connections “has not been fully developed.” His article addresses several cases in which courts considered the extent of required disclosures.

Inadequate disclosure alone is sufficient to warrant denial of all fees sought. *See, e.g., In re Georgetown of Kettering Ltd.*, 750 F.2d 536 (6th Cir. 1984); *In re EWC Inc.*, 138 B.R. 276, 280 (Bankr. W.D. Okla. 1992) (“Violation of the disclosure rules alone is enough to disqualify a professional and deny

¹ *See In re Crivello*, 134 F.3d 831, 836 (7th Cir. 1998) (“[C]ounsel who fail to disclose timely and completely their connections proceed at their own risk because failure to disclose is sufficient grounds to revoke an employment order and deny compensation.”).

compensation, regardless of whether the undisclosed connections or fee arrangements were materially adverse to the interests of the estate or were *de minimis*."); *In re Saturley*, 131 B.R. 509, 516-17 (Bankr. D. Maine 1991) ("Anything less than the full measure of disclosure leaves counsel at risk that all compensation may be denied."). Therefore, prudent professionals—understandably—err on the side of caution and disclose far more than is (or should be) required, for fear of ending up having served *pro bono*. See *Crivello*, *supra*, 134 F.3d at 836; *Park-Helena*, *supra*, 63 F.3d at 882 ("Even a negligent or inadvertent failure to disclose fully relevant information may result in a denial of all requested fees.").

The Dilemma

Rule 2014's "all...connections" clause is overbroad. Even those professionals that make voluminous disclosures of wildly irrelevant "connections" probably do not comply with the literal requirement of disclosure of "all connections" as required by Rule 2014(a). Literal compliance with the unambiguous language in Rule 2014(a) requires disclosures that are unnecessary for a determination of a professional's fitness to act for an estate. Nor is it even possible for a conscientious professional to comply in any but the most mundane and tiny cases. Most cases of any size would require huge or even impossible disclosures that would defeat the intended purpose of the Rule. Simply stated, Rule 2014(a), in its present form, is overbroad. And despite the best efforts of some courts, the rule of reason they espouse is impossibly vague and, accordingly, of little practical utility.

What is a "connection" with a creditor? In any large prospective chapter 11 case, counsel preparing the schedules will learn that the debtor-to-be will be listing dozens of utility companies, national or international equipment or real property lessors and other companies with whom the law firm has had prior dealings. Is it necessary for a law firm that hopes to represent the chapter 11 debtor to disclose that, for example, in a chapter 7 bankruptcy case 10 years before in which the law firm represented the trustee, one of the creditors was AT&T, which happens also to be a creditor in the current case? What if, in a case concluded 10 years earlier, this law firm actually represented AT&T but has had no assignment from that company since? What if the law firm knows that Local Attorney A will be representing the bank, that Local Attorney B will be representing the municipality and that Local Attorney C will be representing a tort claimant in the new case? Should the law firm disclose every case that it ever had in which A, B or C (all

well-respected busy bankruptcy lawyers) were involved? What about the golf dates they shared, the meetings and conferences they attended, and the fact that they are on the same bench/bar liaison committee? Are these not all "connections"? If not, then how is that term defined?

Professionals are not even likely to know of all "connections" they may have that they could be required to disclose. How does a certifying professional really know who all the parties in interest in a case will be, let alone the attorneys and accountants for the yet-to-be-determined parties in interest? For example, what if, unknown to the certifying lawyer, another attorney in the law firm seeking to be employed by the debtor-in-possession (DIP) happens to personally use the services of an accountant who is himself involved in the case? This non-disclosure, under a literal interpretation and application of Rule 2014(a)—and recall that some courts have said that one must comply with the literal terms of the Rule (see, e.g., *Plaza Hotel*, *supra*, 111 B.R. at 883)—would trigger disqualification and denial of fees. Following this example, the fear of being disqualified or having compensation denied might prompt a professional to make blanket or boilerplate disclosures of any and all accounting firms with which she, her firm and any of its other personnel do business. Even worse, because there is no real way for a law firm filing its initial disclosures to know which lawyers and accountants the (perhaps thousands of) creditors may retain (or have already retained) to assist them in the soon-to-be-filed chapter 11 case, a cautious lawyer could reasonably conclude that the law firm's disclosure should include a boilerplate recitation of all connections with all known lawyers and accountants wherever located.

This over-disclosure resembles the overproduction of documents that has long been condemned in the course of litigation discovery: Somewhere in the midst of all the disclosures, there might be something relevant. Thus, the literal terms of the vaguely worded Rule 2014(a), combined with the ever-more-draconian application of the "death penalty" for perhaps minor slip-ups, tend to dilute the purpose of the Rule in the first place.

Another disturbing trend that flows inexorably from the unduly strict application of an unduly vague rule is the strategic use of immaterial nondisclosure to disqualify competent opposing counsel. Parties in, or that anticipate, conflict with the client of the putative counsel have been known to oppose retention based on the counsel's failure to disclose immaterial connections. Worse, such parties may even contest (or blackmail counsel by threatening to contest) counsel's

fees based on the counsel's failure to disclose immaterial connections. This is another unhealthy side effect of courts' overly strict interpretation of a rule that, at least textually, knows no boundaries. The rule virtually begs for courts to impose not a strict interpretation, but a rule of reason.

Recent Cases Fail to Provide Clear Guidance

In his article, Mr. Bowles frames the following issue directly pertinent here: "Is there such a thing as a *de minimis* connection?" *Straight & Narrow*, *15. Acknowledging case law that repeats the widely accepted proposition that all connections, no matter how small, must be disclosed, Mr. Bowles states that the actual holdings of these cases "clearly indicate" that the omitted disclosures "were, in most cases, material to a determination of whether a professional could be employed." *Id.* As an example, he cites the leading case of *Rusty Jones*, *supra*, 134 B.R. at 346, which states that what must be disclosed are connections that are related to a pending bankruptcy case or could "reasonably have an effect on the attorney's judgment in the case."

In *Rusty Jones*, the court explained that "[t]he purpose of disclosure is to permit the court to determine whether the attorney is disqualified or whether further inquiry is needed before making that determination. Therefore, the decision about what to disclose is not left to the prospective attorney 'whose judgment may be clouded by the benefits of the potential employment.'" *Id.* at 345. After recognizing that Rule 2014(a) requires disclosure of "all connections," the *Rusty Jones* court, in apparent recognition of the scope of connections that would have to be disclosed based on a literal application of the language in Rule 2014(a), stated:

This is *not* to say that *every possible connection need be disclosed* by [a professional]. *Rule 2014 does not require a [professional] to dredge up every past connection, however remote, that he or she ever had with the parties in interest in the case... What is important are connections that presently exist or recently existed between the [professional] and parties in interest, and also past connections of business or personal nature that are either related to the bankruptcy proceedings or could reasonably have an effect on the [professional's] judgment in the case.*

Id. (Emphasis added.)

The formulation set forth in *Rusty Jones* has been widely followed. See, e.g., *Kagan v. Lopez (In re San Juan Hotel Corp.)*, 239

B.R. 635, 647 (BAP 1st Cir. 1999) (“Although an attorney need not disclose every past or remote connection with every party in interest, he must disclose those presently or recently existing, whether they are of business or personal in nature, which could reasonably have an effect on the attorney’s judgment in the case.”), *aff’d*, 230 F.3d 1347 (1st Cir. 2000); *Sabre Intern., supra*, 289 B.R. at 426 (“For while retention under §327 is only limited by interests that are ‘materially adverse,’ under Rule 2014, ‘all connections’ that are not so remote as to be *de minimis* must be disclosed.”). Nevertheless, as Mr. Bowles noted, neither *Rusty Jones* nor any other decision “clearly define[s]” what connections could “reasonably affect” an attorney’s judgment. Straight & Narrow, *16.

In a recent decision, one court made an attempt to clarify the standard. According to the court in *In re Molten Metal Technology Inc.*, 289 B.R. 505, 511-12 (Bankr. D. Mass. 2003), two questions must be asked in determining whether non-disclosure should have any bearing on the allowance of a professional’s application for compensation and reimbursement: Was the subject matter a “relevant” consideration, *i.e.*, one that could reasonably have an effect on the attorney’s judgment, and if so, did the subject give the firm an “interest adverse to the debtor or the estate with respect to the matter on which such attorney is to be employed?” *Id.* In a footnote, the court further clarified that, in framing this two-part inquiry, it did not mean to suggest that compensation should be affected only if both inquiries were answered in the affirmative, but that the second inquiry helped define the extent to which the connection, and its non-disclosure, should affect the firm’s compensation. *Id.* at 512 n.13. This formulation is hardly a template for a practicing attorney to follow in determining when a distant “connection” is so remote as to be non-disclosable.

According to *Collier on Bankruptcy*: The term “connection” is an unfortunate one. Arguably, two people are “connected” if they serve together on a charitable board or are even friends. Nevertheless, the courts usually maintain that the requirement to disclose connections will be strictly construed. In bankruptcy practice, there are often numerous “connections” among professionals due to the fact that professionals will interact in many cases. No court has *yet* suggested that the requirement of disclosure includes listing all such relationships. The “connections” cited by

the courts run to fee-sharing arrangements and the like that might affect the court’s decision to approve the employment.

A requirement that a professional disclose all instances of involvement in cases with other professionals could be burdensome. However, the failure to disclose *any connection* will be at the professional’s risk. While serious omissions warrant disqualification of the professional or a reduction, denial or disgorgement of compensation, or even more creative remedies, a court has broad discretion to determine whether the disclosure at issue justifies remedial measures at all.

King, Lawrence P., 9 *Collier on Bankruptcy*, ¶2014.05, at 2014-7 through 2014-8 (15th ed. rev. 2003) (citations omitted) (italics in original, but underscore is added).

The above-quoted language from *Collier* and the above-cited cases suggest that there is a theoretical limit on the disclosures required where the connections are so “remote” as to be *de minimis*, or are at least insufficient to warrant a finding that they could “reasonably affect” a professional’s judgment. But they fail to describe a method for determining when one is approaching that limit. Moreover, these authorities, otherwise consistent with the approach suggested in this article, seem inconsistent with the unambiguous language used in Rule 2014(a) requiring disclosure of “all connections.” See *United States v. Ron Pair Ent.*, 489 U.S. 235, 241 (1989) (if the language of a statute is plain, courts should enforce the statute according to its terms); *Caminetti v. United States*, 242 U.S. 470, 485 (1917) (same). Likewise, *Collier* states that “[p]rofessionals may not make unilateral determinations regarding the relevance of particular connections, or that certain connections to the debtor are too insignificant to disclose. All connections must be disclosed.” 1 *Collier on Bankruptcy*, ¶8.05 at 8-60 (citations omitted). Well, if there is some limit on the disclosures required but that limit is not one for the disclosing party to determine, the logical result is that there is no limit on what must be disclosed.

This conundrum is graphically shown by the *Bennett Funding* case, discussed by Mr. Bowles in Straight & Narrow. As courts frequently have done on this subject, the court in *Bennett Funding* spoke out of both sides of its mouth. First, the court stated that “it is critical to the integrity of the bankruptcy process that disclosure of *material* facts which relate to disinterestedness be timely and thorough.”

Bennett Funding, supra, 226 B.R. at 334. Then, a mere two paragraphs later, it chastised the trustee for his having made repeated determinations of what was material to disclose and what was not. Quoting *In re Granite Partners L.P.*, 219 B.R. 22, 35 (Bankr. S.D.N.Y. 1998), the court warned that a professional “cannot usurp the court’s function by choosing, *ipse dixit*, which connections impact disinterestedness [*i.e.*, which facts are “material”] and which do not.” *Bennett Funding, supra*, 226 B.R. at 335. So, it seems, a professional preparing to disclose its connections must disclose only material information, but, when doing so, may not make the decision about what is material and what is not.

Clarify the Rule

For there to be a real, practical remoteness limit on the need to disclose connections, the better course would be to amend the Rule. The loose cannon of “all of the person’s connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the U.S. Trustee or any person employed in the office of the U.S. Trustee” must be substantially revised. The Rule should state either that only certain types of connections must be disclosed or it should delegate to the U.S. Trustee the duty to promulgate—much as it has done with the task-based billing project and fee application guidelines—the types of disclosures that would constitute a safe harbor. The fees of a professional who completely and honestly discloses the connections designated by the amended Rule, or the resulting U.S. Trustee guidelines, would not be subject to disallowance and disgorgement.

Without such common-sense, practical, easy-to-follow guidelines, more and more otherwise honest professionals will become caught in the trap of the unfairly vague aspirational pronouncement in Rule 2014(a) requiring professionals to disclose “all connections” or will over-disclose to the benefit of no one and the detriment of the true purpose of the Rule. ■

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