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UBP: Has the Pendulum Swung Too Far?

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Editor's Note: *For another article discussing* UBP *and committee formation, see On Our Watch on page 20.*

The American legal profession prides itself on its self-governance. Not only are attorneys required to work within the confines of the law in general, but also under the jurisprudence of the Rules of Professional Conduct as adopted and implemented by each state respectively. These heightened standards are directed toward maintaining the integrity of the profession, largely in response to public perception. The broad terminology utilized by the drafters of the model rules was done so in anticipation of various types of misconduct.


Richard S. Lauter

While generally in harmony with the Bankruptcy Code, the model rules create an interesting and uncomfortable juxtaposition with the Code, specifically those sections pertaining to the formation of a committee of unsecured creditors. The discordance between the solicitation provisions of the rules of professional conduct and those provisions pertaining to the creditors' committee in the Bankruptcy Code recently came to light in the case of *Universal Building Products* (*UBP*).[1] This article examines the relevant issues through a discussion of (1) the history and importance of creditors' committees, (2) the role of professionals in the formation and maintenance of creditors' committees and (3) an analysis of the impact that the *UBP* decision will have on the retention of professionals going forward.

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The Committee


Michael A. Brandess

One of the central issues underlying the conflict between the Bankruptcy Code and the model rules is the perception that while helpful, the committee of unsecured creditors and its professionals come at too great a cost to the estate.[2] The notion that committees offer minimal value to the estate is not only incorrect, but is inherently at odds with one of the central tenets of modern U.S. bankruptcy law: that the debtor or debtor in possession (DIP) owes a fiduciary duty to the creditors. Much like a board of directors representing thousands of shareholders in a large corporation, the committee serves the vital function of maintaining a strong presence throughout the reorganization process.


Brian J. Jackiw

Conjecture regarding the value of the creditors' committee overlooks an underlying principle of chapter 11 reorganizations that "[w]ith the removal of the bankruptcy judge from active administration of the debtor's estate, the creditors' committee is the only entity with statutory authority to closely scrutinize the conduct of the debtor-in-possession during the course of corporate reorganization."[3] In 1978, § 1121(a)(1) of the Bankruptcy Code read that "[a]s soon as practicable after the order for relief under this chapter, the court shall appoint a committee of creditors holding unsecured claims."[4] The notion that time is of the essence denotes the importance that Congress placed on the role of creditors' committees.

More than simply serving to appease the overall unsecured creditor body, the creditors' committee serves a very real and significant purpose in reorganizations. Accordingly, Congress provided committees with authority to oversee case administration, review the debtor's financial condition, evaluate the case's viability and seek the appointment of a trustee if necessary.[5]

Committee Formation and Management

The committee formation process requires appointment as opposed to election, and serving on the committee is not

Feature

1 *In re Universal Building Products*, 2010 WL 4642046 (Bankr. D. Del. 2010).

2 *See* Michelle M. Harner and Jamie Marincic, "Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations," 64 *Vand. L. Rev.* 749 (2011) (highlighting anecdotal evidence to suggest that creditors' committees provide questionable value to unsecured creditor body).

3 Marta G. Andrews, "The Chapter 11 Creditors' Committee: Statutory Watchdog?," 2 *Bankr. Dev. J.* 247, 247 (1985).

4 11 U.S.C. § 1121(a)(1) (1978).

5 Greg M. Zipes and Lisa L. Lambert, "Creditors' Committee Formation Dynamics: Issues in the Real World," 77 *Am. Bankr. L. J.* 231, 231 (2003).

mandatory. Instead, interested creditors must apprise the U.S. Trustee of their interest, denoting their desire to take part. Serving on the committee is a thankless position, often requiring unsophisticated members to make difficult legal and financial decisions. The court in *In re ABC Automotive Products Corp*. adeptly highlighted numerous reasons why creditors are often hesitant to serve on a creditors' committee, including (1) apprehension regarding potential responsibilities, (2) disillusionment after previously serving on an ineffective committee, (3) disinterest in taking on fiduciary duties and (4) unfamiliarity with the committee's role.[6]

Accordingly, despite the significance that the Bankruptcy Code places on the creditors' committee in overseeing the reorganization process, finding members of the unsecured creditor body willing to serve on the committee is frequently a challenge. Reluctant creditors often look to attorneys or other bankruptcy professionals in order to understand the role of the unsecured creditors' committee. For this reason, the Rules of Professional Conduct specify the types of contact a potential committee counsel can and cannot have with a potential committee member.[7]

From the moment that a committee is formed, it is in need of professionals capable of choosing the best course of action. Even in the unlikely circumstance in which a committee member has a sophisticated understanding of bankruptcy law or financial restructuring, few committee members are able to devote the time, energy and expense involved in undertaking the appropriate course of action. For this reason, the Code provides for the retention of professionals to aid the committee in executing its directives.[8]

More than simply a resource for the creditors' committee, retained professionals provide essential guidance. In most restructuring cases, the committee is privy to highly confidential material. For this reason, debtors are generally inclined to negotiate nondisclosure agreements with committee counsel prior to providing access to sensitive documents.[9] Along these same lines, committee counsel provides an added safeguard against breaches of fiduciary duty or insider trading among the committee members.[10]

Despite the numerous benefits that a committee's professional may provide, concerns regarding a professional acting in an unethical manner are at times warranted. In *ABC*, the committee's application to appoint counsel was rejected by the bankruptcy court due to the committee members' complete lack of participation in the counsel selection process other than through proxies held by the selected firm.[11] The court took issue with the procedure utilized by the retained counsel in securing its position. The court noted that the committee meeting was scheduled with little notice, the procedural requirements for raising an objection were onerous and members were informed that their silence would be considered assent.[12] In denying the application to appoint committee counsel, the court clarified that the specific facts of that particular case effectively deprived the committee of its right to participate in significant committee decisions.[13] However, in *dicta*, the court explained that its decision was not intended to deter the use of proxies, and was therefore seemingly limited to the specific facts in *ABC*.

Likewise, courts have sought to ensure that committee counsel remains disinterested in representing the committee. However, "[b]y eliminating the *per se* bar to dual representation in 1984, Congress implicitly determined that the inherent tension between a committee and one of its creditors, standing alone, was immaterial and any conflict too theoretical to warrant being classified as an adverse interest. That is, merely the remote potential for dispute, strife, discord or difference between a committee and one of its creditors does not give rise to any conflict of interest or appearance of impropriety that would bar an attorney from representing both parties."[14] Despite this apparent incongruity, Rule 2014(a) of the Federal Rules of Bankruptcy Procedure requires that all professional persons employed under § 1103 of the Bankruptcy Code submit an affidavit of disinterestedness.

Congress recognized that creditors' committees are essential to the reorganization process. Therefore, the relevant legislation indicates that Congress appreciated that a limited amount of solicitation would be required in order to promote an active committee with qualified professionals.

Universal Building Products

On Nov. 4, 2010, Hon. **Mary F. Walrath** published an opinion in the chapter 11 case of *UBP*. Although her opinion promotes transparency in committee solicitation practices by articulating a bright-line rule prohibiting some of the more egregious solicitation practices, her overly broad condemnation of the conduct in *UBP* will inevitably create more problems than it solves. Specifically, Judge Walrath's efforts to seek clarity to ethical committee solicitation practices through prompting the U.S. Trustee's Office to promulgate additional rules could result in diverse standards from jurisdiction to jurisdiction, differing interpretations of these rules from person to person, and a greater propensity for attorneys to unwittingly breach these rules due to a total lack of uniformity.

In *UBP*, the court found that Arent Fox LLP (AF) and Elliot Greenleaf & Siedzikowski PC (EG) relied on prohibited behavior to secure their appointment as committee counsel.[15] Specifically, AF and EG failed to adequately disclose their relationship with Dr. Haishan Liu, an interpreter and fellow committee professional who had formerly held a proxy for a member of the committee. Specifically, the court learned that although unfamiliar with many of the debtors' largest creditors, Dr. Liu, AF and EG collaborated in their efforts to obtain the proxies of certain foreign creditors to secure their retention with the committee. After successfully being appointed to the committee, Dr. Liu convinced his fellow members to retain AF and EG as committee counsel. However, Dr. Liu, AF and EG failed to disclose the full extent of their preexisting relationships with one another, as well as their tactics in procuring committee member proxies.[16]

Judge Walrath relied heavily on Rules 7.3 and 8.4 of the Delaware Rules of Professional Conduct. Rule 7.3 provides that "[a] lawyer shall not by in-person or real-time electronic contact solicit professional employment from a prospective client when a significant motive for the lawyer's doing so is the

6 *See* 210 B.R. 437, 444 (Bankr. E.D. Pa. 1997).
7 Model Rules of Professional Conduct 7.4 and 8.7.
8 *See* 11 U.S.C. § 1102.
9 *See* Burke Gappmayer, "Protecting the Insolvent: How a Creditor's Committee Can Prevent Its Constituents from Misusing a Debtor's Nonpublic Information and Preserve Chapter 11," 2006 *Utah L. Rev.* 439, 440 (2006) ("Creditors...need access to the debtor's information in order to determine what actions they should take throughout the bankruptcy process, and to ensure that the debtor's conduct is appropriate. Conversely, a debtor with vital nonpublic information has a strong legitimate interest in keeping that information confidential to prevent individuals from exploiting it.").
10 *Id.*
11 210 B.R. at 437.
12 *Id.* at 437.
13 *Id.* at 445.
14 *In re National Liquidators Inc.*, 182 B.R. 186, 192 (S.D. Ohio 1995) (in reference to amendments to § 1103(b) of Bankruptcy Code).
15 *See* Steven Church, "Arent Fox Law Firm Loses Bankruptcy Client When Judge Finds Ethical Breach," Bloomberg.com (Nov. 5, 2011).
16 *Universal Building Products* at at *5-10.

lawyer's pecuniary gain, unless the person contacted: (1) is a lawyer; or (2) has a family, close personal or professional relationship with the lawyer."[17] AF and EG improperly encouraged Dr. Liu in his efforts to solicit creditors *after* they learned that Dr. Liu did not represent any of the debtors' 30 largest creditors. In the opinion, Judge Walrath clarified that soliciting creditors when there is no professional or close personal relationship is against the Rules of Professional Conduct and subjects the attorney to disqualification as committee counsel.

The court added a section entitled, "further recommendations." In this final *dicta*, the court effectively promoted additional disclosure requirements[18] and urged the U.S. Trustee's Office to promulgate additional procedures, including revising the questionnaire for prospective committee members. Judge Walrath declared that:

> The Court hopes that by requiring disclosure of the practice of using others to solicit proxies to act at a committee formation meeting will go a long way to discourage that improper practice. The Court would also urge the [U.S. Trustee] to consider implementing procedures to reduce the likelihood of undue influence on the decision of a committee to hire professionals... Further, the [U.S. Trustee] might consider amending the questionnaire it sends to prospective committee members to include questions regarding whether they were solicited by anyone in connection with the case.

While the court's requirement that professionals disclose their relationships with intermediaries appeared appropriate in a case such as *UBP* where the conduct was relatively egregious, this standard is confusing to bankruptcy professionals going forward. Bankruptcy professionals frequently rely on one another to learn of new employment opportunities. To ignore the realities of law practice is to invite problems down the line.

The standards governing ethical conduct in the committee solicitation process should seek to embody these realities. Financial advisers, bankruptcy attorneys and restructuring consultants all work to develop their networks and reputations in the insolvency community to procure new business. Despite the merits of Judge Walrath's contention that committee solicitation practices require greater scrutiny, the effect of implementing new rules on a district-by-district basis only serves to further complicate the process.

Looking Ahead

This article does not dispute the notion that there are ethical problems in modern committee formation practices. Nevertheless, the belief that more procedures would improve flawed behavior runs contrary to the basic law school principle that "less is more." Unlike tort or contract law, bankruptcy law consists of a uniform set of rules and procedures. To ensure compliance with the ethical rules, it would only seem reasonable that those implementing the procedures strive to create consistent and comprehensible standards. Instead, the *UBP* decision provokes increased rulemaking with divergent implementation of these new rules, with an increased likelihood for inadvertent violations. Therefore, to properly effectuate the purpose underlying the *UBP* decision, such changes should perhaps be implemented through the Administrative Office of the U.S. Courts and the U.S. Trustee's Office with the goal of establishing a uniform, comprehensive and understandable set of procedures pertaining to the committee-formation process. ■

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[17] Del. Lawyers' R. of Prof. Cond. 7.3. Rule 8.4 of the Delaware Rules of Professional Conduct precludes using third parties to violate any of the other rules of professional conduct on behalf of an attorney. *See* Del. Lawyers' R. of Prof. Cond. 8.4.

[18] In addition to her "further recommendations," Judge Walrath added that "while it was not a disqualifying factor, the fact that AF had provided legal advice to two creditors on their right to seek administrative claims is a fact that should have been revealed to the Committee and to the Court."