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Conflicts of Interest & Other Ethical Issues*

Mr. Marc Kieselstein, Honorable Judith Fitzgerald & Professor Douglas Baird

MR. KIESELSTEIN: It's good to see everyone here this morning. We're going to be talking about ethical issues in the bankruptcy practice, and we've been asked to shorten up our presentation some, which is imminently predictable. It always happens with the legal ethics discussion at these conferences. As you probably already know, it's also the least attended class in law school, as I recall. But it is very important, and we want to touch on some of the significant issues.

The first thing to keep in mind is that there is no stand-alone set of ethical rules for bankruptcy lawyers. The Rules of Professional Responsibility and the Canons of Ethics apply as they would in any other area of practice. I would say that in the practice of bankruptcy, and in particular in the mega cases, those rules are sometimes stressed almost to the breaking point. This is because unlike a stand-alone piece of litigation or a transaction when you're sort of looking your adversary in the eye, in the bankruptcy context you have hundreds, thousands, tens of thousands of parties at interest, which is a defined term under the Bankruptcy Code and basically gives anyone the right to step up and be heard on a case if they have some pecuniary interest in its outcome. So you've got to keep in mind all of these variant interests when you take on a representation.

We are briefly going to touch on these stresses in three separate areas. First, is debtor's counsel. When you act as a debtor's counsel, you have to be what is called “disinterested.” That is to say, you can't hold a claim adverse to the estate. They can't hold claims against you and various other touchstones for that test. But you have to be able to make sure that you are in a position where the court believes you're pursuing the debtor's agenda and no other, and you have no conflicting agendas or loyalties that would prevent you from doing that. And we'll talk about how that one in particular situation gets stress tested.

* This is an edited version of the transcript from the third panel at the DePaul Business and Commercial Law Journal Symposium, Mega-Bankruptcies: Representing Creditors and Debtors in Large Bankruptcies, held on April 10, 2003.
Second, on the creditors' side is multiple representations of creditors in a single bankruptcy case. It is very, very common that you will have one lawyer in a mega case that represents 10, 15, 20, 30 different creditors, sometimes similarly situated, sometimes with different agendas. How can that work? How can that possibly be? Is that also a stress point? We'll talk about how to maneuver through that process.

Returning to the role of the debtor's counsel, there's sort of a metaphysical question; that is, when you are debtor's counsel and if it's a debtor you're dealing with, you're by definition in that zone of insolvency or beyond, who are you really representing? Are you representing the debtor? Are you representing the metaphysical estate? Do you owe duties to particular creditors who will tell you, as they always tell me, you're working for me. We, the creditors, own the company. If that's the case, how do I discharge my duties and to whom do I discharge them?

Let me start with the sort of first issue, that is, debtor's counsel, how do you become debtor's counsel? What are some of the pitfalls? To be debtor's counsel, you have to be retained by motion after notice in hearing in the bankruptcy court under Section 327(a) of the Code. And as I said, § 327(a) requires that you be disinterested, and that means you're not a creditor, you're not an equity holder, you're not an insider; that is, you're not an officer or director or one of your partners wasn't the secretary of the corporation, something like that could trip you up, and that you don't hold an interest that's materially adverse to the interest of the estate.

It seems simple enough, but in a mega case, it's not simple at all. What you have to do, sometimes months before you file your case, is run an incredibly comprehensive conflict check. You have to get lists from your client of every stakeholder in the case that might have any significant role to play, and you've got to run those lists through your computer systems.

When you have mega cases and mega firms, and the mega firms tend to be the ones that do the debtor work in the large cases, you are talking about an incredibly involved and inherently imprecise process.

And one of the things I always worry about is when we file our affidavit in connection with your retention motion, we say we're disinterested to the best of our knowledge because that's really the best we can say at any point in time.

HON. FITZGERALD: Well, Marc, you're talking about the soft landing case where you've had time to plan. What happens if you are faced with the fact that somebody's going to file an involuntary in-
stead. To preempt it you file, so you have really got a down-and-dirty case. How do you do that kind of check and when do you do that kind of check?

MR. KIESELSTEIN: Well, I think you say, I’m disinterested, supplement to follow. The three creditors I’ve been able to serve so far have no issues with the other 45,000 that I will get back to you on. And in all of our large cases, we are typically supplementing our retention affidavits on a regular basis.

But there really is very little in the way of a de minimis rule. It’s kind of a bright line rule for whether you’re disinterested or not. And if it turns out you do further investigation and you find you’re not disinterested, you have to disclose. As debtor’s counsel we often take the position that disclosure cures all ills, and it really doesn’t. We’ll talk about a couple of cases where that’s the case.

But, Judge Fitzgerald, if I were to come in three months into the case and file my supplemental affidavit, and it turns out that it’s not necessarily new information, it’s newly discovered information, are you going to tell me I wasn’t disinterested on day one, and I’ve got to give back the millions of dollars of fees I’ve generated in that period of time?

HON. FITZGERALD: Well, the Third Circuit, unfortunately, is pretty strict about that. And I think if it turns out that you’ve developed an actual conflict or you recognize that you now have an actual conflict, there may be some requirement to make a disgorgement of fees.

But I don’t feel it is my obligation to raise those issues on my own. I think the creditors should be raising them. They should be monitoring them. If I see a problem with the disclosure statement, you’re probably not going to be counsel—not probably, you won’t be counsel going forward. But I don’t know that I’m going to challenge what you did in good faith unless somebody raises that issue.

And I hope that’s not in violation of Third Circuit law because the Third Circuit’s pretty tough on making judges have an obligation at looking at fees, but not necessarily at the appointment application itself as it gets modified from time to time.

MR. BAIRD: May I ask, what counts as a threshold for conflict? Just so you understand the depth of the problem, if you’re working for a relatively small Midwestern firm like Kirkland & Ellis, you’ve got partners you’ve never seen before. They have clients all over the place. It’s inconceivable that in any large case Kirkland & Ellis is not going to be actively representing people who are creditors of United.
MR. KIESELSTEIN: In matters unrelated to the debtor.

MR. BAIRD: Well, but that's—so that's one threshold you think is okay.

HON. FITZGERALD: Well, I think the tougher case is where firms have merged and there was no conflict by the firm that represented the debtor on the date the bankruptcy was filed. But then the merger happens, and by the time they get the computer systems to read each other and find out their client lists, if the case is still pending, because sometimes it can take that long, you can develop an actual conflict.

MR. BAIRD: Yes, but let's define what an actual conflict is. Now, if it's one of your partners representing a creditor of United but not representing that creditor against United in a different matter, that's going to be okay.

MR. KIESELSTEIN: That's going to be okay.

HON. FITZGERALD: It has to be disclosed.

MR. BAIRD: If you disclose it.

MR. KIESELSTEIN: Yes.

MR. BAIRD: Now, what if your partner is going to be the creditor's counsel in the United case? Is that enough to—are you dead? Can you give up the other representation?

HON. FITZGERALD: I think you make a balancing test, don't you, as to which of the clients you want to keep.

MR. KIESELSTEIN: Yeah. And that would be an easy one in virtually any scenario. We do have situations where we're coming up to a filing and we see that there is someone down at the other end of the firm in the London office or something who has some ongoing dispute with the mega company that you're about to file or will be filing soon.

That's what the screening process is meant to do. And then, you know, Jamie Sprayregen gets on the phone and has a conversation with the other partner, and somehow or another it gets resolved, and that other representation gets dealt with by replacement counsel. You still disclosed that in the period prior to the filing you had this issue, and you dealt with it in an appropriate way.

HON. FITZGERALD: Are you subject to being sued by the client you gave up?

MR. KIESELSTEIN: Well, clearly you want to reach a consensual understanding. You don't want to just cut and run. Yes, you abandon your client, you've got your Canons of Ethics, your Rules of Responsi-
bility with respect to that client, so you deal with it on a case-by-case basis, and hopefully you don’t rupture the relationship by having this one issue dealt with by somebody else.

HON. FITZGERALD: Can you get a waiver?

MR. KIESELSTEIN: There are some things that are waivable and some things that are not waivable. I don’t think I would want to come into your courtroom and say, well, we got waivers from United, and we got waivers from the other parties, so we’re going to be on both sides of this dispute.

HON. FITZGERALD: Probably not.

MS. MILLER: There is a distinction, though, between getting a waiver of something that’s a conflict versus the ethical rules that require you to vigorously represent your client, and that’s not something that I see as waivable in the same way as a conflict would be.

MR. BAIRD: What about this? How about if one of your partners is representing shareholders in the United bankruptcy, can you represent creditors?

MR. KIESELSTEIN: No.

HON. FITZGERALD: And the debtor, no, absolutely not.

MR. BAIRD: Okay. Let’s say it’s a corporation that has subsidiaries, can you represent both at the same time?

MR. KIESELSTEIN: Well, this is an issue with affiliated debtors.

MS. MILLER: But doesn’t part of the answer for that depend upon the extent to which there are loans between the related entities?

HON. FITZGERALD: Or claims back and forth that would have to be cross-computed.

MS. MILLER: Or claims.

MR. KIESELSTEIN: That is part of the issue. I think this is an issue that’s going to come up more and more as you see more cases that involve substantive consolidation. If you’re debtor’s counsel for the parent and the 28 related entities and you’re advocating for substantive consolidation, by definition, you’re going someone’s ox. For people who don’t know, substantive consolidation means that you’re going to take all of the assets and liabilities of various corporate entities that are separate corporate entities, and you’re going to, for lack of a better term, mush them together so you have one pot of assets and one pot of liabilities, which is going to have the inevitable effect of increasing the return to some creditors in the solvent estate or more
insolvent estates, and decreasing the return to creditors in the less insolvent estates.

HON. FITZGERALD: A case to watch along that score, Judge Wolin, the same judge who wrote the Sealed Air opinion, has a substantive consolidation trial going on right now in the Owens-Corning case.

MR. KIESELSTEIN: Yes.

MR. BIENENSTOCK: In the situation you just posited, whose conflict is it? And what I mean by that question is, let's say each of the holding company and its subsidiaries had separate counsel. They still answer to the same C.E.O. and the same board of directors as the holding company. So if you're concerned about that, is there any answer other than having a separate trustee for each subsidiary and the holding company? Because the conflict from the way I see it is not generated by the attorney or the accountants. It's the one control person for all the entities. So you can have a separate trustee for each entity and a separate creditors' committee. And so you'll have—in the average mega case, you'll have 25 trustees' and creditors' committees to deal with—

MR. BAIRD: Or in Enron you'd have 3,000 trustees and 3,000 —

MR. BIENENSTOCK: That's right.

MR. BAIRD: The path that gets you in a world where you say a lawyer can't represent a parent and the subsidiaries, is a path to madness. That world is just not going to work. It's not a responsible way to run a bankruptcy. It just costs too much money. You're going to be spending too much money on lawyer's fees and not enough money on maximizing the value of the estate.

MR. KIESELSTEIN: And I completely agree with that. The question is when you get into situations where judges are being very literal, as we've seen in a number of contexts of late, about what constitutes standing or what the drafters of the Code meant is what they said, then you might run into issues where someone says I hear you. It's a problem.

And we'll talk about it in a minute, the Pillowtex case, where a bright line rule is applied, and people say let the chips fall where they may. That's what Judge Grady is saying in the critical trade case in the Northern District. So if literalism is the wave of the future, then you're going to run into issues like this where the practical realities, unfortunately, give way.

HON. FITZGERALD: Well, I don't know that there is a circuit that's more literal in its interpretation of the Bankruptcy Code than
the Third. Even if in the *Marvel Entertainment* case, looking at trustee conflicts, makes some distinction between a potential and an actual conflict and the fact that you don't have to have separate trustees for related entities unless there is going to be this conflict that develops and a suit or an action or something has to be brought against another.

Now, that is talking trustees, not counsel for the debtor. But since the debtor in possession is the trustee in the Chapter 11, I think there could be some analogy that would work.

MR. BAIRD: Unfortunately, there's not a disinterestedness requirement for the debtor-in-possession in the way there is for counsel. But if I could just try to generalize and give the yin and the yang of this.

The perspective from bankruptcy lawyers is to say look, the rules that we're talking about were designed with this idea of A suing B. It's one-on-one litigation. Outside of bankruptcy where I'm a lawyer, and I write wills for lots of different people in town. In fact, two of the people might be suing each other and each represented by a lawyer in that transaction. It doesn't mean that I can't write a will for these two people.

A lot of what happens in bankruptcy is negotiations, discussions and so forth that don't have the characteristic of being actual litigation. But even though they don't have the characteristic of being an actual litigation we apply the conflict rules for litigation. This is problematic. Bankruptcies are not about A suing B. It's about 3,000 debtors filing at the same time and tens of thousands of creditors. You want to figure out the problems at relatively low cost.

You try to make that argument, however, to people who aren't bankruptcy lawyers who are involved with rules of professional responsibility, and they say, "you're engaging in special pleading." We hear it all the time. Everybody claims they're special. You're no different than anyone else. Live with it.

And that's the debate that you hear over and over and over again. Ideally we'd like to get beyond that. But if you're strictly mechanical and strictly literal, you quickly get the results that just aren't sensible.

MR. KIESELSTEIN: Right.

HON. FITZGERALD: Well, can you—let's not talk for a minute about *Pillowtex*. Just one other question on the issue of a different type of disinterestedness, creditor representation. Let's say you are not disinterested for a period of time, can you cure that defect, not a financial one, but a representational defect. Can you cure it?
MR. KIESELSTEIN: I would think so. I mean, some would say you can't unring the bell, but I would think that there are ways. There are fixes that one could create to resolve the situation and allow you to then go forward. What happens in the period of time when you aren't disinterested? Do you have to pay back your fees for that period of time or it's—

HON. FITZGERALD: Can you get special counsel appointed under some circumstances to represent the entity with which you might have a conflict, assuming you can get their waiver to permit that to go on?

MR. KIESELSTEIN: Well, in lots of large cases now, there are conflicts' counsel that are retained at the inception of the case basically saying this is a big, huge, sprawling case, there are going to be situations, I can't necessarily identify them today, where I'm not in a position to go forward as debtor's counsel because there will be some conflict situation. But I'm going to put a prophylactic device in effect right now. This other counsel will be there to handle all of those situations so everyone can rest assured that there won't be problems.

Now, it begs the question of, well, what do you mean? Why do you need conflict counsel? Tell me the X, Y and Z of all of that, and I'll decide whether or not that's a Band-Aid or a cure that I'll accept. But I think it's a practical approach, as the professor said, for dealing with a situation where conflicts are more or less inevitable.

MR. BIENENSTOCK: There's a hard and fast ethical rule that you cannot sue current clients.

MR. KIESELSTEIN: That's right.

MR. BIENENSTOCK: It is inevitable in the large cases that the debtor's counsel or sometimes the committee that's going to be suing on avoidance actions and the like will affect current clients.

MR. KIESELSTEIN: Right.

MR. BIENENSTOCK: So even if the current client were to waive and give consent, you wouldn't have the right appearance. It would look wrong. So we often have conflicts' counsel, and in these really large cases, one firm can't do it all anyway. It's not even efficient for one firm to do it all. So the conflicts' counsel I think has been rightfully accepted as the right solution.

HON. FITZGERALD: Well, let's tell them about Pillowtex.

MR. KIESELSTEIN: Sure, let's move on to Pillowtex. Jones Day represented Pillowtex, a textile company.
Let me take a minute to explain preferences. Preferences are payments made within the 90 days prior to the filing of the bankruptcy case, but under certain circumstances can be recovered by the debtor post petition and spread evenly pro rata across the creditor body. It’s meant to serve as a disincentive to people and prevent them from knocking down the door when a company is experiencing financial difficulties. It only exists inside of a bankruptcy case, but it is potentially a large source of recovery, particularly in these mega cases for creditors.

Any one you pay within the 90 days is a potential preference defendant, including your lawyers. And as part of your schedules that you file after you file for bankruptcy, you have to list out all the payments that you made within the 90 days before you filed.

Here Jones Day received approximately a million dollars in the 90-day period before they filed. They went into court under Section 327(a) to get retained and disclosed the fact that they had received these payments within the 90 days. No creditor had any issue with them being retained as debtor’s counsel. But the U.S. Trustee, and the U.S. Trustee is an odd duck, is in essence the ombudsman of the bankruptcy process that exists in every judicial district, and what they’re there for is to make sure that the process retains its integrity and is done in accordance with the rules, et cetera. They don’t have a pecuniary interest in cases, but they have a right to come in and be heard on virtually any issue in the case.

The U.S. Trustee came in and said we’ve seen the disclosure about these payments. We think it might be a preference. We don’t really know, but it might be, and, therefore, they may not be disinterested, and, therefore, they shouldn’t be hired.

Jones Day said this is silly. We don’t think it’s a preference, but in case it is, what we’ll do is we’ll agree if we are found to have received a preference, we will, of course, return the money, and we will waive any claim that we have when we return the money.

Normally when you give back a preference, which is, after all, just a payment for goods and services, there’s no moral component to preferences. You just got paid in a time frame where you have to give it back. You get a claim for that amount. You give back a thousand dollars of real dollars and you get a claim for a thousand bankruptcy dollars, whatever percentage that ultimately turns out to be. So they’re going to give back that money, and they say, no problem, if there’s ever a preference, we’ll cure it that way.

District courts sitting in bankruptcy said that’s fine, no problem, you’re retained. The U.S. Trustee pursued its quest appeals. The case
rolled along. Plaintiffs confirmed it was a successful case by all accounts, and then the Third Circuit came down with a ruling about six months ago that says those prophylactic devices are not good.

You have to make a determination on the front end of the case whether or not this creditor is—or this party is disinterested or not. So you have to go through, I guess, a preference trial or the equivalent of it right at the inception of the case to make a threshold determination about whether the law firm is disinterested or not. And having failed to do that, the court remanded down to the district court and said let’s figure out if there’s a preference. If there was, then they never were disinterested, and since they were never disinterested, they weren’t eligible to be hired in the first place, and every dollar of their fees is potentially at risk. That’s the implication.

So it’s a real sort of gotcha situation. One could argue that the debtor’s counsel was on notice, but what was the debtor’s counsel to do on the first day of the case? They’d received the monies. They had a choice. They could—

MR. BAIRD: Give all the money back.

MR. KIESELSTEIN: They could give the money back and just say even though I don’t think it’s a preference, I’m giving it back because some day it might be, and that’s the cost of doing business.

MS. MILLER: Well, one of the suggestions that I raised when we were talking about this earlier this morning was, wouldn’t it have been sufficient for them to have put the money into an escrow account and have it sitting there and agree to waive their claim in the event that it was subsequently determined that it was a preference?

MR. KIESELSTEIN: I don’t think so because I don’t think the creditworthiness of Jones Day was at issue.

MR. BAIRD: The question is, would the lawyer for the debtor in possession aggressively pursue that preference action?

MS. MILLER: I guess the other side of the coin on that, Doug, is, can they even defend that action because they’re then taking action against the estate which clearly puts them in the adverse position?

HON. FITZGERALD: Surely they could get counsel to represent them.

MR. KIESELSTEIN: Special counsel on both sides.

MR. BAIRD: In Enron I think the—with respect to I think the counsel for the creditor’s committee, they agreed to basically roll over—
MR. BIENENSTOCK: Well, what happened was the examiner determined that they had received a preference, and while the examiner was not a judge, it was the better part of discretion from Milbank saying here's the money. We waive the claim. Let's put that behind us.

HON. FITZGERALD: See, I think the problem in Pillowtex is based on the fact that in the Price Waterhouse opinion in the Sharon Steel case years ago, the Circuit took a look at the fact that Price Waterhouse had not been paid about $900,000 prepetition for work that it had done.

So it came into the bankruptcy holding a claim for $900,000, and it did not agree at the outset that it would either waive the claim or not vote on the plan. Then as the hearing went on, it agreed that it would not vote on the plan, but it still wanted to have its claim. So the issue goes up to the Circuit, and the Circuit decided, no, you can't have a claim in a bankruptcy as a professional and still represent the debtor. They're not disinterested.

So now the question is, well, all right, if I can't have a claim—

MR. KIESELSTEIN: And I can't take the payment.

HON. FITZGERALD: Well, no, what professionals were doing was not taking the payment, which they hadn't been doing because it had been helping their client's cash flow situation before, but now they're taking the payment because otherwise they can't continue to represent the debtor. Well, the problem with Pillowtex is, now Pillowtex has said you would have had a claim if you hadn't taken the payment. You shouldn't have taken the payment because it's a preference; therefore, you still have a claim so you're not disinterested.

So you're in a Hobson's choice. I think the only thing you can do, and I suppose this will work, is always work against a retainer. I know in some states, I believe in California, and I'm not a California law expert, but I had this issue once, so I guess it's maybe still the case, retainers are deemed to be paid in full and earned in full when paid. So I don't know if that solves the problem. No, that's not the case?

MR. KIESELSTEIN: It depends on the kind of—

MR. BIENENSTOCK: Not according to the U.S. Trustees.

HON. FITZGERALD: Oh, well, okay. Then if that's the case, it's not an issue. I was concerned that if you had a fully earned retainer before you had provided any services, then you've got a fraudulent conveyance on your hands. So I didn't see how you could get around it.
In states where that isn't an issue and you can take a retainer and bill against services, I think maybe the whole legal world of insolvency practice and for every professional in it is just going to have to get to the point where they are always working against a retainer.

MR. KIESELSTEIN: And as a practical matter, one of the things we tell new clients is if we're stupid enough to become one of your creditors, you don't want us as your bankruptcy counsel.

So we get a healthy retainer up front. Our billing practices are not the normal billing practices where we send you an invoice every month telling you what it is. We replenish that retainer on a regular basis and we calculate it so we're staying ahead of the game, not just for billed time, but also recorded and unbilled time.

And the problem is that when you have a client that by definition is in extremis or close to it, and you are in essence dunning them virtually every Friday, you know, "Where's my wire transfer?" you have already created a level, not of adversity, but a level, of tension in your relationship you'd rather not have.

MS. MILLER: And by not doing that, and if you get behind the eight ball, you can't necessarily get out from representation of that client, particularly if you're involved in litigation. You're having to seek authority from the court, and you may not get out.

HON. FITZGERALD: Well, that's the other problem. Just because you're disinterested, if you're in the middle of a litigation when that happens, the court may say too bad, you're in. You made the mistake. You're in until this is over, and then we'll say goodbye.

MS. MILLER: You know, the other point to make, that people tend to forget about that aren't as experienced, is you have § 328(c) of the Code; any point along the way until fees become subject to a final order, the interim order is all along—any point in time disinterestedness can be raised, adverse interest can be raised, and if it's found by a court at that point in time that you were not or you haven't made a subsequent affidavit under the Federal Rules to disclose changed circumstances and you're found in that case to violate it, any time that you have incurred or anything you will have received in the case is going to be subject to disgorgement.

MR. KIESELSTEIN: And there's a range of court decisions about what the sanction is for either not disclosing something or simply failing the disinterestedness test, either looking backward or whatever. And some of those opinions are the death penalty basically. Every dollar back and never another dollar coming to you. Some try to be
more measured in their approach, but they say, look, if you're not disinterested, you can't be counsel. If you're not counsel, you can't be paid; therefore, you have to give it all back.

HON. FITZGERALD: Well, can this one be cured? You've received the preference. It's identified in the application process. The court doesn't hold a whole evidentiary hearing but says to you, this one looks kind of like you've got a preference. What are you going to do about it? You say, fine, we'll give the money back and waive any claim that we have. Has that cured the disinterestedness for the period of time that you were counsel until you gave the money back and waived the claim?

MR. KIESELSTEIN: This has spread like wildfire throughout the U.S. Trustee system. In fact, after the opinion came out, the U.S. Trustee general counsel, in the executive office in Washington, wrote an article and said whatever the inconvenience or practical problems presented, time and attention must be spent to assure the conflicts of interest are addressed fully and in a manner consistent with the Bankruptcy Code. And Pillowtex should serve as an important reminder that some of these conflicts will be disqualified regardless of the prophylactic steps that are taken.

HON. FITZGERALD: And he's a former Chapter 7 trustee himself, so he's familiar with what we're talking about.

MR. KIESELSTEIN: So we've seen, for instance, in the United case where a financial professional was alleged by the U.S. Trustee to have received a preference, that it got settled, but eventually the settlement was, well, you're just not going to get paid your monthly fee the first two months of the case. So you're not actually giving back your preference, but you're taking a holiday from getting your fee paid and then all is forgiven.

Now, whether that was an effective cure under the Pillowtex line of thinking, I don't know. Judge Wedoff didn't seem to be troubled by it. So this is an issue that's of great concern. Rick left so I didn't hear the rest of the story after the remand. I think it's still being discussed down at the district court level. So certainly something to keep in mind.

The second stress point I wanted to talk about is multiple creditor representation. To give an example from the United case, there we had public debt in that deal, aircraft securitizations where there were literally hundreds of public debt holders. There was an ad hoc committee formed with a particular counsel rounding up his clients to represent their interests as a whole. The problem was, they didn't file a
statement which you’re required to file. It’s the Rule 2019 statement that tells the world that you represent multiple parties in this case so that the court knows, so that the debtor knows, so that your other clients know in fact that you are representing not merely them but a bunch of other people as well. And in that situation, the securitization instruments had various tranches of debt. You had the A holders who got paid before the B holders who got paid before the C holders. And you had counsel loading too much onto their shoulders trying to represent people in each tranche, inherent conflict of interest between people who had different rights and priorities and, in fact, had subordination agreements between them contractually.

And it took a while to tease that issue in the court, and ultimately Judge Wedoff said I don’t really see how you can take on this multiple-creditor representation because it’s inherently riddled with conflict. They don’t have a disinterestedness requirement when they come in, but they are subject to the Rules of Professional Responsibility and the Canons of Ethics.

And we don’t do a lot of creditor work, but if any of the creditors’ counsel, if they’re still around, I don’t know how people actually manage some of those situations. Sometimes it’s creditors to trade creditors who have the same side of interest. They both want the debtor to reorganize so they can collect as much as they can on their prepetition claim, and there is no point where their interests are not locked.

MS. MILLER: What about when you’re representing multiple creditors on the front end and then one of them becomes subject to the preference action? Those creditors who are not subject to the preference action want that money repaid.

MR. KIESELSTEIN: Correct.

MS. MILLER: It is impossible to not have a conflict in continuing to represent the other creditor that’s subject to the preference defense who doesn’t want to put money in that’s ultimately going to go to their benefit.

MR. KIESELSTEIN: Which happens every day.

MS. MILLER: It happens all the time.

ROBERT BERNSTEIN: In the Bankruptcy Code, there’s nothing that says that a creditor representative can’t have a conflict of interest, right?

MR. KIESELSTEIN: No, and we’re not—

ROBERT BERNSTEIN: It’s under—we’re talking about the professional rules.
MR. KIESELSTEIN: Yes.

ROBERT BERNSTEIN: Which also allow conflicts of interest with disclosure and waiver, and so long as the counsel can make the determination that the conflict doesn’t impair her ability to represent either.

MR. KIESELSTEIN: Which may well occur.

ROBERT BERNSTEIN: Well, it’s possible.

MR. KIESELSTEIN: Yeah, sure.

MS. MILLER: The question is going to come to whether it is a waivable conflict in the first case.

ROBERT BERNSTEIN: Everything’s waivable.

MS. MILLER: Oh, no, I don’t think everything is waivable.

MR. BAIRD: It could get a little more complicated. Let’s say if you were not only a creditor, but also serving on the creditors’ committee.

ROBERT BERNSTEIN: Well, that may be different because you have fiduciary responsibilities to the committee and to the case. But just as a creditor representative, there are lots of conflicts that you could maintain and have waived.

MR. KIESELSTEIN: Absolutely. And it’s just when it’s refracted through the prism of a large case where issues like the one alluded to can arise at any time, it’s very hard to strike that balance. And I would guess there are lots of situations where local counsel take on representations as they sort of come in the door, don’t go through the process of explaining to their client all the situations in which these issues may come up and interests may diverge.

MR. BAIRD: Just to give an example in a large case, you’ve had the same law firm representing in *Enron* both JP Morgan and Arthur Andersen. Both are clients of very longstanding. JP Morgan is on the creditors’ committee. How can you sort that out? Can the firm continue to represent either in the case?

MR. KIESELSTEIN: That was the Milbank issue in *Enron* where they wanted to be committee counsel and people said they cannot be because they represent all these potential targets in litigation, et cetera. And Judge Gonzalez said, I don’t see it as a problem. I’m oversimplifying. And an article came out shortly thereafter—I don’t remember what publication—called “The Death of Conflicts.” I was wondering why they don’t exist in bankruptcy anymore.
GARY PLOTKIN: You know, what bothers me is what's called the Sprehagen Rule (phonetic). For a debtor to have a zillion other—

MR. KIESELSTEIN: I'm sorry, which rule was it?

GARY PLOTKIN: The Sprehagen Rule. But if you have a public company with 9 zillion subsidiaries, there has to be inherent conflicts within those subsidiaries. There just has to be. And you say, no problem, it's for the economy of the case. And then when you have one attorney representing 20 creditors going to a meeting as opposed to 20 attorneys, you say conflict, can't do it. That bothers me.

HON. FITZGERALD: See, I don't see that there are necessarily always inherent conflicts in the subsidiaries. Many times the subsidiaries are done for some business and tax purposes, and they're really not an operating entity. They may have siphoned off some assets or hold some debt or something like that—

GARY PLOTKIN: That's a conflict, siphoned off assets, hold debt?

HON. FITZGERALD: No, no, I mean siphoned off in a negative sense. Let me amend the statement. I just mean they may be holding some of the assets of the estate for tax purposes, but in fact they all operate together in one unified entity, and they do consolidated balance sheets.

GARY PLOTKIN: We had one down in Florida a year ago, byebye-now.com. It was one of these public companies that was here today, gone tomorrow. The subsidiaries were totally solvent, at least two of them were, and the parent was totally insolvent, and the judge didn't see a conflict. But to me there's an absolute conflict there.

MR. KIESELSTEIN: Well, I guess I would say a couple of things. One, in lots of cases where the subsidiaries are in essence sort of joined at the hip with the success of the parent—take United for instance. You've got the airline, and then you've got a subsidiary that runs the Mileage Plus program, okay, and obviously they're different entities, they have different sets of creditors. One may be more insolvent or less insolvent. But the success of that subsidiary that runs the Mileage Plus program is inherently and inextricably linked to the success of the airline. And a reorganization for one is, maybe not for every single creditor — I don't know, is going to be good for the overall enterprise.

GARY PLOTKIN: But United has subsidiary regional carriers. I don't know if they do or they don't anymore.
MR. KIESELSTEIN: They’re not subsidiaries. It’s just contractual relationships.

GARY PLOTKIN: Like United Express, is United Express still—

MR. KIESELSTEIN: Third parties.

GARY PLOTKIN: So they’re not from preceding?

MR. KIESELSTEIN: No.

GARY PLOTKIN: But if they were in preceding, would you be able to represent them?

MR. BIENENSTOCK: I don’t know.

MR. BAIRD: Well, can you represent both Enron’s trading entity that’s generating cash and other entities that aren’t and that actually would like some of that cash to go to their creditors? Is that possible?

MR. BIENENSTOCK: Well, we do that. And the solution in Enron is that we have an examiner—

MR. BAIRD: But that I think is your problem.

MR. BIENENSTOCK: We have two examiners that look at a host of issues including issues that might pit one group of creditors against another, and if they’re not negotiated out by the creditor groups, there are other means of bringing the actions. And we determined which is the best law firm—it could be a committee law firm or it could be a debtor law firm—to bring it. But that’s been much more efficient than having each debtor have a separate committee and a separate management.

HON. FITZGERALD: I think a separate committee and separate management in cases that have 1660— that Canadian case that was filed with 999 subsidiaries, you can’t manage cases like that. I just—I don’t know that it’s necessarily a conflicts issue.

I think if an actual conflict issue developed, you’d have to figure out a way to manage it, but I just can’t imagine that there’s so much of an inherent conflict that you can’t start with the idea that if they’re operating as an integrated entity, that you can have one attorney. And then if something shows that you’re wrong, you fix it.

MS. MILLER: One other issue that we talked about this morning, and I know it was brought up last week when I was at another conference, and I think it’s a fascinating issue having to do with the ethical rules regarding solicitation and the formation of creditors’ committees. Do you want to talk about that at all?

HON. FITZGERALD: How can you do it except in writing?
MS. MILLER: You can’t under the rules, and I’m not sure that people really appreciate the nuances between the two, and what actually goes on in practicality.

MR. KIESELSTEIN: Yes. In the relatively short number of days that elapse between a filing and a formation meeting, there is lots of talk and chatter, and it's not—very little of it is in writing. And, frankly, it would be impractical, again, for it all to be that way. And what happens at the formation meeting is you've got a parade of law firms, financial professionals that outnumber the creditors, generally speaking, coming in, doing their pitches, saying why they should be retained in that case, going and trying to get—jockey for this creditor or for that creditor's support, it's back office—it's backroom stuff.

MS. MILLER: And basically what the ethical rules in most of the states say, unless this is an existing client, you can't communicate with them other than by in writing. So if you want to call someone that you have a contact with that you know someone at the company who you find is on the top 20, and because of knowing them you think that you can schmooz with them and get them to support you, you have violated the ethical rules if you haven’t done it in writing.

ROBERT BERNSTEIN: Just a quick point on that, Marc. It's one thing for the bankruptcy court to look at the disinterested requirement of its own code and say it's not practical to impose on a mega case with 3,000 subsidiaries. But I think Judy's point is a good one; it's quite another thing for practitioners to violate the Code—the disciplinary rules. And the bankruptcy court, while it may have some impact on that or some opinion on that, isn't the final word if you're out there soliciting in violation of your state's Code?

MR. KIESELSTEIN: It's not something the bankruptcy court would even have jurisdiction over. Someone could drag a firm in front of the disciplinary board and say this is not something that's permissible, and it's not for Judge Wedoff or any other judge to say otherwise.

HON. FITZGERALD: Well, in Pennsylvania many times, though, the ethical issues are reported to the disciplinary board. They come back to us saying there's a court forum to deal with this. You're better equipped to look at the issue than we are, and they refer it back. So I don't know the jurisdictional issue, but they end up on the docket.

MR. KIESELSTEIN: It's clearly a complicated set of issues that gets lost in the noise sometimes, and one of these days it's going to crop up.