

A Cautionary Tale Of Creditor Connections

Law360, New York (December 9, 2010) -- A recent memorandum opinion of the U.S. Bankruptcy Court for the District of Delaware serves as a cautionary tale, reminding professionals of the critical importance of fulsome disclosure of creditor connections and review of applicable rules of professional conduct in connection with committee engagements. The opinion specifically requires additional detail in professionals' disclosures with respect to the use of any other persons to solicit proxies from creditors, and may change the processes by which unsecured creditors committees are formed and select their professionals in Delaware bankruptcy cases.

In the Universal Products case, the Official Committee of Unsecured Creditors filed applications to retain two law firms as co-counsel. The employment application for one of the firms also requested authority for the committee to utilize the services of a Chinese translator, Dr. Haishan Liu of U.S.-China Assets Management USA LLC, to meet the participatory needs of the committee's co-chair, Eastern Accessories Corp. (EAC), a Chinese company.

The initial declaration in support of that employment application stated that Liu was involved with the case since the petition date and served as proxy for EAC at the committee's organizational meeting. The declaration also disclosed that the law firm represented Liu in nonbankruptcy matters, and represented parties, including unsecured creditors' committees, in other cases in which Liu or U.S.-China Assets Management USA LLC acted in various capacities. The initial affidavit submitted in support of the other proposed law firm's retention application did not disclose a connection between that law firm and Liu.

The Office of the U.S. Trustee (the UST) objected to the committee's proposed retention of one of the law firms, arguing that the firm had failed to timely and adequately disclose its connections to creditors, specifically EAC and another Chinese company on the list of largest creditors, Shanghai Hualin Hardware (SHH), as required by Federal Rule of Bankruptcy Procedure 2014.

The debtor objected to the committee's engagement of both law firms, arguing, that their retention should be denied because, in addition to the alleged inadequacy of disclosure under 2014 raised by the UST, the firms allegedly used Liu to solicit Chinese creditors in contradiction to the requirements of rules of professional conduct applicable to attorneys.

After discovery, the law firms' filing of supplemental disclosures intended to provide further disclosure, and subsequent briefing, the bankruptcy court denied the employment applications. In its memorandum opinion, the court made various findings including as follows.

On the bankruptcy filing date, attorneys at the law firms that the committee proposed to employ sent copies of the bankruptcy petition and the list of 30 largest creditors to Liu. Liu testified that he also received these documents from three other law firms. Each of the firms who sent information to Liu had a prior relationship with him, representing him or his clients. Several of the firms had served as committee counsel in cases where they worked with Liu while he was involved as a translator or representative of an Asian creditor. The court found that Liu understood that the law firms sent him the creditor information because they sought an opportunity to represent the committee.

The bankruptcy court further determined that at the time of the debtor's bankruptcy filing, neither of the committee's proposed law firms had a relationship with any of the Asian creditors on the largest creditors list, nor any knowledge that Liu had a relationship with any of those creditors. In fact, Liu did not represent any creditors on the creditor list. However,

Liu made extensive efforts to contact the Asian creditors on the list, to educate them on the bankruptcy code and determine if they would grant him a proxy to represent them at the committee formation meeting (at which counsel would be selected).

While seeking proxies from the Asian creditors, Liu sent consistent updates to the committee's proposed law firms, and asking them for legal advice regarding how the creditors could have a better chance of recovering amounts due for goods in transit, noting "getting a proxy is a two way traffic." One of the committee's proposed counsel advised Liu that the creditors could seek administrative priority for goods under section 503(b)(9) of the Bankruptcy Code.

Two of the Asian creditors, EAC and SHH, agreed to give Liu their proxies, which included the right to vote on EAC's and SHH's behalf for committee counsel. At the committee formation meeting, the UST selected EAC, but not SHH, to serve on the committee. The committee then selected the two law firms to serve as its counsel. After this appointment, one of the committee's law firms recommended that Liu be hired as a translator for EAC.

Based on its findings, the bankruptcy court determined that the law firms and Liu were acting together to cold-call creditors to obtain proxies to attend the committee formation meeting and vote the proxies for the law firms to serve as the committee's counsel. The court held that there were sufficient facts to suggest that the law firms violated rules 7.3 and 8.4 of the Model Rules of Professional Conduct and Delaware's Rules of Professional Responsibility with respect to solicitation of prospective clients.

The court further concluded that this conduct was sufficient to disqualify the firms as committee counsel. Additionally, the bankruptcy court determined that, although the law firms supplemented their disclosures after the engagement disputes commenced, the subsequent disclosures did not cure the initial lack of disclosure of Liu's attempt to obtain proxies from creditors and this warranted denial of the employment applications.

In conclusion, the court expressly stated it would require that professionals disclose any use of other persons to solicit proxies to act at a committee formation meeting, hoping that this requirement would "go a long way to discourage that improper practice." All professionals seeking to be engaged by a committee in Delaware in particular should keep this disclosure requirement in mind and avoid any solicitation of nonclients prohibited by applicable rules of professional conduct. The court also urged the UST to consider the establishment of procedures to reduce "undue influence" in committee decisions on professional hiring.

The procedures recommended by the court include keeping creditors in attendance at a formation meeting in a separate room from professionals that do not represent any of them, and the potential amendment of the form questionnaire that the UST sends to prospective committee members to include questions regarding whether they were solicited in connection with the bankruptcy. It remains to be seen how the UST will address the court's recommendations. However, the bankruptcy court's ruling may have a significant impact on the way committees are formed and select professionals.

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