Law360
Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

# Debtor's Counsel, Be Careful Who You Help

*Law360, New York (March 05, 2013, 5:28 PM ET)* -- In January 2013, the U.S. Trustee in the In re GSC Group Inc. Chapter 11 bankruptcy cases filed a motion asking that the Bankruptcy Court for the Southern District of New York disallow pending fee requests of the debtor's financial adviser and counsel, disgorge fees already paid, and vacate the orders approving their retention.

The U.S. Trustee's basis for seeking such relief — in part, that debtors' counsel and financial adviser allegedly failed to disclose necessary relationships, including a prohibited fee-sharing arrangement between the financial adviser and an independent contractor — highlights the potential sanctions debtor's counsel may face when assisting debtor-retained professionals with retention applications and other filings.

In fact, the debtor's counsel, financial adviser, and the independent contractor have since entered into separate settlement agreements with the U.S. Trustee. As a result, the parties will disgorge over $2.5 million in fees, with debtor's counsel alone paying $1.5 million, and will subject themselves to further oversight and sanctions. Such serious penalties show that, no matter how competent counsel's representation of the debtor may be, counsel's fees are always at risk when disclosure issues arise.

## Background

GSC Group Inc., an investment management firm, first received financial advisery services from Capstone advisery Group LLC in February 2009. After filing for bankruptcy in August 2010, GSC received court approval to retain Capstone as its financial adviser and Kaye Scholer LLP as its counsel.

As debtors' counsel, Kaye Scholer assisted Capstone with various filings, including Capstone's retention application and a twice-amended declaration by an executive director of Capstone. In such documents, many of which Kaye Scholer's lead attorney allegedly filed under his own name, Capstone represented that it was not party to any fee-sharing arrangement and that the lead consultant in charge of the Capstone efforts in the GSC bankruptcy was a Capstone employee.

As later disclosed, however, the lead consultant was not a Capstone employee. Rather, he was an independent contractor, having executed a consulting agreement (the consulting agreement) with Capstone in February 2006. Per that agreement and its amendments, Capstone compensated the consultant based in part on a percentage of the revenue that the consultant generated by the hours that he and others at Capstone billed.

In 2006, prior to GSC's bankruptcy filing, the consultant allegedly asked the lead Kaye Scholer attorney on the GSC cases, a business and personal contact, to review the consulting agreement. According to the pleadings filed by the parties in the case, the lead attorney provided comments on that agreement, as well as subsequent amendments drafted in later years (including during the bankruptcy case). Meanwhile, Kaye Scholer assisted the consultant with the creation of two business entities (collectively, with the Capstone consultant, the consulting entities) and subsequently represented those entities in two bankruptcy cases unrelated to the GSC bankruptcy.

After the July 2011 sale of GSC assets to Black Diamond Capital Management LLC, the consultant, through one of his business entities, became the liquidating trustee of the GSC estates. Capstone, meanwhile, sought approval of a $3.25 million performance fee for its role in the asset sale. The U.S. Trustee objected to the fees and the parties commenced discovery, at which point the U.S. Trustee learned of the consulting agreement. The U.S. Trustee then filed its motion to disallow the fee requests of Capstone and Kaye Scholer, to disgorge their already-paid fees, and to vacate the orders allowing the debtors to retain Capstone and Kaye Scholer.

### The U.S. Trustee's Allegations and the Parties' Responses

In a lengthy motion comprising more than 100 pages, the U.S. Trustee alleged that Kaye Scholer, Capstone and the consulting entities breached multiple provisions of the Bankruptcy Code and Bankruptcy Rules regarding the duty to disclose various connections to parties in the case, the prohibition against fee-sharing, and the requirement that parties be disinterested. At the core of the U.S. Trustee's myriad allegations of impropriety was the failure of Kaye Scholer, Capstone and the consulting entities to fully disclose their relationships to other parties in the case, particularly the fee-sharing arrangement between Capstone and the consultant.

The U.S. Trustee invoked Rule 2014, which requires that an entity's application for retention by the debtor disclose, among other relationships, "all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants." This duty, and its implied requirement of continued disclosure, was alleged to have been violated when Kaye Scholer, Capstone, and the consulting entities failed to divulge the extent of their relationships, and, as a result, the consultant's independent contractor relationship with Capstone.

Although Kaye Scholer argued that it ran conflict checks for and adequately disclosed connections to any entities retained by the debtors, the U.S. Trustee asserted that Kaye Scholer should have disclosed to the court the multiple relationships between the consulting entities, Kaye Scholer, and the lead attorney on the GSC cases, including Kaye Scholer's formal representation of the consulting entities in other matters and the lead attorney's advice to the consultant about the consulting agreement. To the U.S. Trustee, such connections called into question the disinterested status of the parties — a requirement under § 327(a) of the Bankruptcy Code.

Furthermore, the U.S. Trustee rejected Kaye Scholer's proposition that, as debtors' counsel engaged in the common practice of assisting a debtor-retained professional with bankruptcy court filings, it looked solely to Capstone to provide accurate information for Capstone's own filings. Instead, the U.S. Trustee argued that, because Kaye Scholer lawyers knew of the Capstone consultant's independent contractor status, they should not have filed Capstone documents containing inaccurate statements regarding that relationship. According to the U.S. Trustee, the lead attorney's knowledge of the consulting agreement made it inexcusable that Kaye Scholer filed inaccurate pleadings on Capstone's behalf.

Furthermore, the U.S. Trustee implied that, even if the lead attorney was not familiar with the contents of documents filed under his name, the other Kaye Scholer attorneys working on the GSC cases should have done more to ensure the accuracy of the Capstone filings. The U.S. Trustee took particular issue with the Capstone declarations prepared by those attorneys, as the declarations not only identified the consultant as a Capstone employee, but stated that Capstone was not engaged in any prohibited fee-sharing arrangements in violation of § 504(a) of the Bankruptcy Code. The U.S. Trustee also argued that when those same attorneys learned of the consultant's independent contractor status later in the GSC cases, they should have corrected any erroneous disclosures filed previously.

Based in part on the above circumstances and arguments, the U.S. Trustee concluded that such serious harm was done to the essential bankruptcy concepts of full disclosure and truthful filings that it warranted disallowing the parties' fee requests, disgorging fees already paid, and vacating the orders approving the retention of Capstone and Kaye Scholer in the GSC cases.

## Lessons for Debtor's Counsel

The U.S. Trustee's motion in the GSC cases highlights the importance of full and accurate disclosure of relationships in every bankruptcy case. Although all professionals must take care to accurately disclose their relationships with others involved in the case, debtor's counsel must be particularly vigilant.

As the GSC cases show, the common practice of debtor's counsel assisting debtor-retained professionals with bankruptcy court filings puts debtor's counsel at additional risk, as counsel must not only ensure adequate disclosure of its own connections, but must supplement its disclosures as needed and confirm that it is following best practices when assisting debtor-retained professionals with their documents. If debtor's counsel fails in these duties, it may well face the serious sanctions sought by the U.S. Trustee in the GSC cases. However, debtor's counsel can limit its risk by considering some of the lessons that the GSC cases offer.

First, debtor's counsel should be aware that prior knowledge of or relationships stemming from an unrelated matter can cause disclosure issues. In the GSC cases, the formal and informal relationships between Kaye Scholer, its lead attorney, and the consulting entities became fodder for the U.S. Trustee's argument that Kaye Scholer and its lead attorney failed to disclose connections relevant to the bankruptcy cases. This failure to disclose brought into question whether the lead attorney and Kaye Scholer were disinterested parties, as required by the Bankruptcy Code. Even worse, it connected Kaye Scholer to another alleged Bankruptcy Code violation — that of a professional's prohibited fee-sharing arrangement.

Second, debtor's counsel must ensure that its firm has adequate internal controls and procedures in place regarding the preparation of documents for debtor-retained professionals. In the GSC cases, the U.S. Trustee criticized the Kaye Scholer attorneys who prepared the Capstone declarations, as the declarations did not disclose the consultant's status as an independent contractor, despite the fact that the lead Kaye Scholer attorney had advised the consultant with respect to the consulting agreement. To avoid such criticism, debtor's counsel should establish sufficient controls and conflict procedures to ensure that all possible connections to other parties in the case are fully disclosed. With such policies in place, debtor's counsel will be less likely to inadvertently prepare documents that the firm knows or should know are not true.

Finally, debtor's counsel should be cognizant of the need to update and supplement disclosures as needed. In the GSC cases, the U.S. Trustee targeted the Kaye Scholer attorneys for not making supplemental disclosures once they learned that the consultant was an independent contractor. Thus, it is in the best interest of debtor's counsel to continually reassess prior disclosures, paying particular attention to their accuracy and evaluating whether new developments require the firm to file supplemental disclosures.

**Conclusion**

As mentioned, Kaye Scholer, Capstone and the consulting entities have since reached settlement agreements with the U.S. Trustee. Pending court approval, these agreement require the parties to pay over $2.5 million in fees to the GSC estates, with Kaye Scholer alone paying $1.5 million.

According to the agreements, the consulting entities must resign as liquidating trustee and Capstone must cease serving as the liquidating trustee. In addition, Kaye Scholer, Capstone, and the consulting entities are subject to more rigorous policies for monitoring and ensuring adequate conflict checks and disclosures.

In particular, Kaye Scholer must retain an outside policies expert, implement that expert's recommendations, and conduct training sessions regarding those new policies. It must also establish a committee to interview the partner managing any bankruptcy case regarding retention applications and certify in writing that proper disclosures were made.

The GSC cases provide an important reminder to debtor's counsel engaged in the common practice of assisting debtor-retained professionals with bankruptcy filings. While in most cases it may be useful and acceptable for debtor's counsel to assist professionals in this manner, in lieu of such professionals retaining their own counsel at a greater cost to the estate, debtor's counsel must be aware of the pitfalls of such actions.

Debtor's counsel must not only ensure the continuing accurate and adequate disclosure of its own relationships and information, but must also confirm that it is following best practices regarding the preparation of documents for debtor-retained professionals.

--By Douglas R. Gooding, Sean M. Monahan, and Megan B. Felter, Choate Hall & Stewart LLP

*Douglas Gooding is chairman of the finance & restructuring group at Choate Hall & Stewart in Boston. Sean Monahan is a partner in the firm's finance & restructuring group and Megan Felter is an associate at the firm in Boston.*

*The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*

All Content © 2003-2013, Portfolio Media, Inc.