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Ethical Considerations in Solicitation of Creditor Committee Engagements

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ABI CAMBRIDGE

Ethical Considerations in Solicitation of Creditor Committee Engagements

I. Hypothetical

A chapter 11 case files, and the debtor identifies its twenty largest unsecured creditors. Prior to the meeting to form the official committee of unsecured creditors (and, by extension, any committee appointment), a financial advisor that is not representing any parties in interest and is otherwise unconnected with the case contacts creditors identified on the "top twenty" list to see if they wish to participate on a conference call prior to the formation meeting to discuss the case. The financial advisor makes this contact with the intent of building a relationship with creditors and (hopefully) being selected as the financial advisor for the to-be-formed committee.

The financial advisor invites Law Firm with which it has handled prior committee engagements to participate on the call.

1. What are the ethical and legal questions that Law Firm should consider?

2. Can/should Law Firm participate on the call?

A. Analysis

Initially, for uniformity purposes, this memorandum addresses the above-referenced scenario/questions under the assumption that the Model Rules of Professional Conduct ("MRPC") control. *See In re Meridian Automotive Sys. – Composite Operations, Inc.*, 340 B.R. 740, 744 (Bankr. D. Del. 2006) (noting that MPRC govern conduct before Delaware district court, bankruptcy court).

A. Key Ethical Issues

1. MRPC 7.3 – Direct Contact with Prospective Clients

a. MRPC 7.3

> (a) A lawyer shall not by in-person, live telephone or real-time electronic contact solicit professional employment from a prospective client when a significant motive for the lawyer's doing so is the lawyer's pecuniary gain, unless the person contacted

(1) is a lawyer; or
(2) has a family, close personal, or prior professional relationship with the lawyer.

(b) A lawyer shall not solicit professional employment from a prospective client by written, recorded or electronic communication or by in-person, telephone, or real-time electronic contact even when not otherwise prohibited by paragraph (a), if:
(1) the prospective client has made known to the lawyer a desire not to be solicited by the lawyer; or
(2) the solicitation involves coercion, duress or harassment.

(c) Every written, recorded or electronic communication from the lawyer soliciting professional employment from a prospective client known to be in need of legal services in a particular matter shall include the words "Advertising Material" on the outside envelope, if any, and at the beginning and ending of any recorded or electronic communication, unless the recipient of the communication is a person specified in paragraphs (a)(1) or (a)(2).

(d) Notwithstanding the prohibitions in paragraph (a), a lawyer may participate with a prepaid or group legal service plan operated by an organization not owned or directed by the lawyer that uses in-person or telephone contact to solicit memberships or subscriptions for the plan from persons who are not known to need legal services in a particular matter covered by the plan.

B. Specific Issues Raised by Scenario

(1) **Would Law Firm's participation on the call constitute the "solicit[ation] [of] professional employment?"**

- Some courts have employed a "totality of the circumstances"- type test to assess whether the communication rises to the level of a solicitation, including the background of the parties, the parties' previous relationship, the attorney's conduct, and the words spoken. *See In re Charges of Unprofessional Conduct Against 97-29*, 581 N.W.2d 347, 350 (Minn. 1998).

- In the scenario posed, and without getting into what Law Firm's attorney(s) may say on the call, there are a number of facts present in the scenario which should give Law Firm pause: (1) the fact that the parties to the call (with the exception of financial advisor) are all potential committee members; (2) the fact that the call is occurring immediately prior to committee formation; (3) the fact that Law Firm is the only law firm on the call; and (4) the fact that the

purpose of the call is to "discuss the case." Additionally, the scenario indicates that financial advisor and Law Firm have worked on prior engagements together – if they have done similar calls prior to such engagements previously, that fact would be germane to the analysis.

- Again, putting aside what Law Firm's attorney(s) say on the call, any suggestion by Law Firm that "discussing the case" in that context had some benign purpose unrelated to the solicitation of potential business (e.g., educating the trade industry about bankruptcy) would likely be dismissed by a reviewing court, especially when Law Firm appears at the formation meeting and "pitches" the committee.

(2) **If the ultimate goal of the Law Firm is to be employed by the committee (that is, Law Firm has no interest in representing one/more unsecured creditor(s) in their individual capacities), do one/more unsecured creditor(s) listed on the "top twenty" list constitute (a) "prospective client[s]" in a situation where the committee has not been formed?**

- In the scenario posed, there is little doubt that the parties to the call – unsecured creditors on the debtor's "top twenty" list – are the most likely candidates to be appointed to an official committee of unsecured creditors. The issue is whether communication with prospective members of the client (which has yet to be formed) runs afoul of MRPC 7.3.

- "Prospective client" is defined in MRPC 1.18(a) (see below) – "a person who discusses with a lawyer the possibility of forming a client-lawyer relationship with respect to a matter is a prospective client." Practically speaking, if Law Firm is ultimately not selected as counsel to the official committee, some interesting questions flow from how the "prospective client" is defined for purposes of compliance with MRPC 1.18 – is it (a) the official committee (once it is formed) and its members in their capacities as such, (b) the individual creditor(s) who participated on the telephone call, regardless of whether they were selected, or (c) some combination of both (a) and (b)? In other words, which entity/entities are you directing your ethics department to enter onto the firm's conflict database?

- If Law Firm participates on the call and subsequently is charged with a violation of MRPC 7.3, it would be gambling on the hope that a reviewing court would adopt the "no committee, no prospective client" view (to the extent that it cannot avail itself of the Rule's "safe harbor"). Given the facts of the scenario we are discussing, this strategy appears to be extremely risky at best, wrong at worst. *See* Michael P. Richman, *Chasing Committees: The Ethics of Entertainment Solicitation*, AM. BANKR. INST. J., Oct. 2003, at 18 (noting that, "where the

purpose of the solicitation is in fact employment from a prospective client, and the person being solicited is being solicited precisely because of the expectation that a person will have a role in making the employment decision, a distinction based on a literalist reading of the rule would appear to be evasive.").

(3) **Are the unsecured creditor(s) on the call persons that fall within the "safe harbor" of MRPC 7.3(a)(1, 2)?**

- In the scenario posed, we do not know what the answer to this question is.

- The plain language of MRPC 7.3(a)(1, 2) indicates that Law Firm would be able to solicit professional employment from a prior client consistent with its terms.

- Even if participants on the call fall within the "safe harbor" of MRPC 7.3(a)(1, 2), Law Firm has to carefully communicate the preliminary nature of its contact to the participants and clearly state that confidences would not necessarily be protected in order to avoid a subsequent argument by the "prospective client" that a professional relationship should be implied. *See Bridge Prods., Inc. v. Quantum Chem. Corp.*, No. 88 C 10734, 1990 WL 70857 at *6 (N.D. Ill. Apr. 27, 1990) ("By putting their prospective clients on notice that there is no attorney/client relationship as yet, [law firms participating in interviews] can avoid the possibility of having one imposed on them by law because of the potential client's misperception about the safety of their confidential disclosures.").

2. MRPC 1.18 – Duties to Prospective Client

a. MRPC 1.18

(a) A person who discusses with a lawyer the possibility of forming a client-lawyer relationship with respect to a matter is a prospective client.

(b) Even when no client-lawyer relationship ensues, a lawyer who has had discussions with a prospective client shall not use or reveal information learned in the consultation, except as Rule 1.9 would permit with respect to information of a former client.

(c) A lawyer subject to subparagraph (b) shall not represent a client with interests materially adverse to those of a prospective client in the same or a substantially related matter if the lawyer received information from the prospective client that could be significantly harmful to that person in the matter, except as provided in paragraph (d). If a lawyer is disqualified from

representation under this paragraph, no lawyer in a firm with which that lawyer is associated may knowingly undertake or continue representation in such a matter, except as provided in paragraph (d).

(d) When the lawyer has received disqualifying information as described in paragraph (c), representation is permissible if:

(1) both the affected client and the prospective client have given informed consent, confirmed in writing, or:

(2) the lawyer who received the information took reasonable measures to avoid exposure to more disqualifying information than was reasonably necessary to determine whether to represent the prospective client; and

(i) the disqualified lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom; and

(ii) written notice is promptly given to the prospective client.

b. Assuming that there is a "prospective client" in the scenario (see discussion above), two separate duties are owed.

(1) Duty of confidentiality (MRPC 1.18(b))

(2) Duty of loyalty (MRPC 1.18(c, d))

- Query whether Law Firm is ready for whatever occurs on the telephone call. What if a creditor blurts some information out about its own situation during the call that could be "significantly harmful" in a different context?

B. Related Ethical Issues

1. Would Law Firm's discussion of the case on the telephone call constitute the provision of something of value in exchange for recommending Law Firm's legal services to the committee upon its formation? *See* MRPC 7.2(b) (lawyer prohibited from "giv[ing] anything of value to a person for recommending the lawyer's services" except in limited circumstances); Michael P. Richman, *Chasing Committees: The Ethics of Entertainment Solicitation*, AM. BANKR. INST. J., Oct., 2003, at 18, 58.

2. Law Firm would need to be aware of the proscriptions of MRPC 7.1 (lawyer prohibited from making false or misleading communication

regarding the lawyer or the lawyer's services) and MRPC 7.4(d) (lawyer prohibited from stating or implying that the lawyer is certified as a specialist in a particular field of law unless requirements of Rule met) before participating on the call.

3. MRPC 8.4 – Misconduct

a. MRPC 8.4

It is professional misconduct for a lawyer to

(a) violate or attempt to violate the Rules of Professional Conduct, knowingly assist or induce another to do so, or do so through the acts of another;

(b) commit a criminal act that reflects adversely on the lawyer's honesty, trustworthiness or fitness as a lawyer in other respects;

(c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation;

(d) engage in conduct that is prejudicial to the administration of justice;

(e) state or imply an ability to influence improperly a government agency or official or to achieve results by means that violate the Rules of Professional Conduct or other law; or

(f) knowingly assist a judge or judicial officer in conduct that is a violation of applicable rules of judicial conduct or other law.

- As an aside, Law Firm's use of financial advisor as a "runner" for Law Firm would not obviate ethical concerns posed by scenario. *See* MRPC 8.4(a).

C. Legal Issues

1. Impact of ethical violation on Law Firm's ability to be employed by the committee

- Overreaching by Law Firm either before or during committee "beauty pageant" process may lead to firm's disqualification from representing the committee. There is authority suggesting that a court may enjoin an attorney from prosecuting actions which are the fruits of an impermissible solicitation. *See*

State ex rel. Beck v. Lush, 103 N.W.2d 136, 138-39 (Neb. 1960); *Atchinson, T. & S. F. Ry. Co. v. Andrews*, 88 N.E.2d 364, 371-72 (Ill. App. Ct. 1949).

2. Bankruptcy fraud – 18 U.S.C. § 157

A person who, having devised or intending to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice or attempting to do so –

* * *

(3) makes a false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under title 11, including a fraudulent involuntary bankruptcy petition under section 303 of such title, at any time before or after the filing of the petition, or in relation to a proceeding falsely asserted to be pending under such title,

shall be fined under this title, imprisoned not more than 5 years, or both.

- Theoretically, Law Firm could be criminally liable if it intentionally makes false statements on the call to secure support for its bid to become committee counsel.

B. Conclusion

In response to the questions posed:

1. What are the ethical and legal questions which Law Firm should consider?

See above.

2. Can/should Law Firm participate on the call?

If all of the potential committee members on the call fall within the "safe harbor" identified in MRPC 7.3(a), Law Firm may participate on the call. If the potential committee members on the call fall within the "safe harbor" identified in MRPC 7.3(a), the question of whether Law Firm should participate on the call requires that Law Firm weigh the potential advantages of participation versus the "cost" of compliance with applicable provisions of the MRPC.

II. Solicitation of Creditors' Committees Using Written Materials

A. Initial Marketing Materials

May Law Firm put together marketing materials and mail them to the twenty largest creditors in a recently-filed chapter 11 case?

Generally, Law Firm may solicit representation of a creditors' committee by sending the 20 largest creditors marketing materials so long as those marketing materials include the words "Advertising Materials." Specifically, MRPC 7.3 (c) states:

> Every written, recorded or electronic communication from a lawyer soliciting professional employment from a prospective client known to be in need of legal services in a particular matter shall include the words "Advertising Material" on the outside envelope, if any, and at the beginning and ending of any recorded or electronic communication, unless the recipient of the communication is a person specified in paragraphs (a)(1) or (a)(2) [lawyer or has a family, close personal, or prior professional relationship with the lawyer].

In 1978, the United States Supreme Court held that in-person solicitation by a lawyer of prospective employment may be regulated by state bar authorities or even banned. *Ohralik v. Ohio State Bar Ass'n*, 436 U.S. 447, 457-58, 464-66 (1978) (Court upheld Ohio's ban on in-person solicitation by lawyers after attorney visited 18 year-old automobile accident victims in hospital to solicit representation). Since then, the Court has distinguished in-person contact from targeted mailings of written solicitation materials. In 1988, the Court interpreted Kentucky's version of MPRC 7.3 to allow mass mailings to a general population who might find offered legal services valuable. *Shapero v. Kentucky Bar Ass'n*, 486 U.S. 466 (1988) (solicitation relating to foreclosure lawsuits). In *Shapero*, the Court raised a concern that certain communications, such as in-person communications, could be intimidating and potentially create undue influence. Ultimately, however, the Court determined that targeted, direct-mail solicitation "pose much less risk of overreaching or undue influence than does in-person solicitation." *Id* at 475. The Court also reaffirmed the *Ohralik* ruling by holding that state regulatory agencies could supervise and regulate abusive advertising practices by, among other things, require the lawyer to file any solicitation letter with a state agency. *Id.* at 476-77.

In 1993, the Court reaffirmed its ruling in *Shapero* by holding that the State of Florida's solicitation ban for CPAs violated the free speech guarantees of the First and Fourteenth Amendments. *Edenfield v. Fane*, 507 U.S. 761, 113 S.Ct. 1792 (1993). The Florida ban on CPA solicitation did not regulate advertisement like MRPC 7.3, but rather entirely prohibited a CPA from any direct, in-person, or uninvited solicitation to a person

or entity that was not already a client. The Court distinguished a CPA's solicitation from the solicitation tactics employed in *Ohralik* because CPAs were soliciting sophisticated and experienced business executives. *Id.* at 762. The Court did not believe the State of Florida's concern to prevent fraud or overreaching statements by a CPA required a blanket ban on all solicitation materials. *Id.* at 769. **Law Firm may use this *Edenfield* analysis to argue that its initial marketing materials should not require the "Advertising Material" tag on the envelope and cover letter. However, to date, there are not any cases specifically discussing what a lawyer must disclose in the initial marketing materials.**

There is only one reported case dealing with a law firm's solicitation of the members of a creditors' committee, *In re ABC Automotive Products Corp.*, 210 B.R. 437 (Bankr E.D. Pa 1997). In *ABC Automotive*, a law firm, through its relationship with the debtor's principal, obtained proxies to represent four members of the unsecured creditors committee. Using the proxies, the law firm retained itself as committee counsel and filed its application to be employed as committee counsel. At the same time, the law firm used the proxies to revoke the engagement of another law firm brought in by a workout specialist/liquidator who had solicited members of the creditors committee. The revoked law firm and the U.S. Trustee objected to the application. No committee members signed or were served with the application to approve the law firm's appointment as committee counsel, and none were contacted or participated thereafter before the hearing on the appointment. The court denied the application holding that the procedure to appoint counsel "smacks of the much maligned attorney activism" and was improper. *Id.* at 445.

In addition, MRPC 7.1 requires that all communications must be truthful, not be misleading, and not be likely to create unjustified expectations regarding fees or results. The prohibition regarding the creation of unjustified expectations would preclude solicitation materials regarding results obtained on behalf of a specific client, such as the amount of a damage award or the lawyer's record in obtaining favorable verdicts, as well as client testimonials or client endorsements. *See* Comment to MRPC 7.1. Therefore, strict adherence to MRPC 7.1 could reduce the impact of the initial marketing materials to generally educating the creditor about the chapter 11 bankruptcy process and potentially providing any information that Law Firm could have gleaned from the first day pleadings or representations made during the first day hearing.

Pursuant to MRPC 7.3, Law Firm also would have to disclose how it became aware of the identity of the 20 largest unsecured creditors. While this requirement may easily be satisfied in the cover letter, it should not be overlooked.

What happens when bankruptcy attorneys have a client or professional contact sitting on a recently-appointed committee?

There is no question that the contact may independently, and without solicitation, recommend that the committee use Law Firm as committee counsel. The answer becomes less clear when Law Firm requests that the contact circulate Law Firm's initial marketing materials to the other committee members. Since MRPC 7.3 requires the phrase "Advertising Material" unless the recipient is a lawyer or has a close personal, or

prior professional relationship with the soliciting lawyer, prudence suggests that any marketing materials provided through the contact contain the "Advertising Material" language. As discussed in more detail in section C below, it also would be sensible to disclose the nature of the relationship between Law Firm and the contact in the initial marketing materials. Indirectly, this disclosure may provide Law Firm an opportunity to highlight past victories to the committee members.

Finally, if Law Firm has a pre-existing relationship with any of the 20 largest unsecured creditors, Law Firm would not need to include the solicitation language in those respective marketing materials. Thus, Law Firm should determine if it has any contacts with the 20 largest unsecured creditors before it sends out the initial marketing materials. The safest course of action would be to direct any communications to the creditors' attorneys as opposed to the creditors themselves because most state bars to not regulate solicitation communications among attorneys.

B. Follow-Up Correspondence with Twenty Largest Creditors

Can Law Firm follow up with the creditor to whom initial marketing materials were sent?

As discussed above, professional conduct rules restrict communications with prospective clients. In particular, Comment 5 of MPRC 7.3 instructs the soliciting attorney to cease efforts to communicate with the prospective client if the lawyer does not receive any response to the initial solicitation. To do otherwise would violate MPRC 7.3(b). Thus, on its face, the answer appears to be no.

What if the cover letter contained in the initial marketing materials contained language stating that Law Firm will follow up with the creditor to determine if it has received the materials?

Pursuant to MPRC 8.4, it is professional misconduct for a lawyer to violate or attempt to violate the Rules of Professional Conduct, knowingly assist or induce another to do so, or do so through acts of another. If Law Firm is using the follow-up telephone call to do anything other than confirm that the intended recipient actually has received the initial marketing materials, then such communication could be construed as an attempt to solicit a committee counsel engagement in violation of MPRC 7.3(b). Moreover, Law Firm could risk discipline by bar disciplinary authorities if it retains a third party to make follow-up telephone calls.

When Law Firm's secretary called the creditor to see if creditor had received the initial marketing materials, would it be proper for the secretary to ask the creditor if it would be acceptable for Law Firm to follow up with creditor to discuss the recently-filed bankruptcy case?

This type of communication ventures closer to the gray area that the Rules of Professional Conduct are attempting to control. Thus, because there are not any cases or comments to instruct attorneys here, there is risk associated with allowing a secretary or another third party to explore future communications with the creditor. Nonetheless, so

long as the secretary preserves the right for the creditor to control the outcome of future communications, *i.e. determine whether the creditor wants to talk to Law Firm*, a reasonable argument could be made that the spirit of the Rules of Professional Conduct have been followed.

C. Disclosure of Conflicts and Connections

If Law Firm is collaborating with another professional, such as a financial advisor, to solicit the 20 largest unsecured creditors, it should disclose this connection to the creditors. Bankruptcy Rule 2014 requires professionals to disclose "any proposed arrangements for compensation, and to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee." The term "connections" has been broadly construed. *See, e.g., In re Kings River Resorts, Inc.*, 342 B.R. 76 (Bankr. E.D. Cal. 2006)(professional holding unwaived potential prepetition claim for damages on any theory, even if not reduced to cause of action or adjudicated, is deemed to have a connection with the debtor). While Bankruptcy Rule 2014 may not apply to the initial marketing materials, if the committee ultimately seeks to retain Law Firm, Law Firm will have to disclose this relationship. *See, e.g., In re Etoys, Inc.*, 331 B.R. 176, 196-198 (Bankr. Del. 2005) (creditors' committee counsel was admonished for failing to disclose the hiring of a professional in a previous bankruptcy case and the existence of their joint ownership relationship in a limited liability corporation providing asset disposition services to troubled companies).

D. A Potential Modification to These Ethical Considerations?

Should solicitation of a potential committee member to employ Law Firm as committee counsel fall outside the restrictions on lawyer advertising?

As discussed above, over time courts have loosened the restrictions regarding lawyer advertising. Possible exceptions, such as the sophisticated business executives referred to in the *Edenfield* case, may open the door for law firms to solicit members of a creditors' committee through advertising. A law firm might contend that the members of the committee are analogous to the sophisticated and experienced business persons in *Edenfield* and are not likely to be unduly persuaded by the initial marketing materials of a law firm with whom they have no prior relationship.

See also Gulf Oil Co. v. Bernard, 452 U.S. 89, 102-104 (1981) (order banning communications with actual or potential class members is inconsistent with Federal Rule of Civil Procedure 23; any order restricting such communications must be made on a specific showing of abuses or potential abuses.). In *Gulf Oil Co.*, the Supreme Court held that an order banning communications with actual or potential class members is inconsistent with Federal Rule of Civil Procedure 23 concerning class actions**.** To restrict communications between parties to a class action law suit, their counsel, and potential members of the class, a court must make finding reflecting a weighting of the need for the limitation and the potential interference with the parties' rights. *Id.* at 102. In future

cases, the bankruptcy court could enter an order allowing law firms to communicate directly with the committee members, or, conversely, requiring law firms to send marketing materials to the United States Trustee's office rather than directly to the committee members.[1] This solution would empower the court to determine how creditors are communicated with in the case, similar to an order limiting notice requirements.

III. Sample E-Mails From Outside Professionals Soliciting Committee Votes in Bankruptcy Case Titled "*In re* Debtorco"

A.

Mark:

I assume you are aware of this filing. Sounds as if it was well-orchestrated. PNC is the largest creditor – claim of $ 20+ million.

B.

Mark:

It was a pleasure talking to you earlier this week regarding my firm's interest in representing the Official Committee of Unsecured Creditors of Debtorco, Inc., et al. As discussed, please find attached our presentation that gives you further background and information on our firm's Bankruptcy and Reorganization group and on certain of our lawyers that would be staged on this representation. We are more than happy to provide any further information and discuss further at your request.

As discussed, as the largest unsecured creditor, PNC will have significant weight on the determination of counsel for the Committee and we would appreciate the support of PNC in pursing our bid to represent the Official Committee of Unsecured Creditors of Debtorco, Inc. Please let me know whether PNC will support our bid.

Kind Regards,

C.

Mark:

Please give me a call regarding this case at your earliest convenience on my cell.

Thanks.

215-555-1111

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[1] The United States Trustee Program has not endorsed this approach.

D.

Dear Mark:

Hope all is well. Debtorco, Inc. and several of its affiliated (the "Debtors") filed voluntary petitions for relief under chapter 11 of the United States Bankruptcy Code today in the United States Bankruptcy Court for the District of Delaware. The Debtors are leaders in their industry. They operate out of facilities on Pennsylvania, New Jersey and Florida.

In reviewing the petition and list of largest unsecured creditors we noticed PNC was listed on the list of largest unsecured creditors. We attach a copy of the petition and List of Largest Creditors filed in the case for your review.

Our firm is exploring the possibility of representing the Official Committee of Unsecured Creditors that will be appointed in the case. J. Palmer Cass and I, both shareholders in our Wilmington, Delaware office are spearheading our efforts in this regard. We understand the Official Committee will be appointed within the next two weeks, and we welcome the opportunity to discuss the bankruptcy case, and committee formation meeting with your earliest possible convenience.

Best Regards,

E.

Mark:

This case just filed in Wilmington. PNC is the largest unsecured creditor. It looks like a case that is destined for a quick 363 sale. Let me know if there is anything we can do.

F.

Hi Mark:

We receive the daily list of new filings in Wilmington and in this morning's list, we found that Debtorco filed yesterday and that PNC is the largest unsecured creditor.

As PNC is generally a secured creditor in these cases, I wanted to make you aware of a service we offer to all of our clients. With the Creditors' Committee formation meeting in a week or two here in Wilmington, we generally offer to attend the meeting with your proxy to get you on the committee and to pick professionals. This service is without charge to our clients, and of course, we would hope and expect that you would allow us to promote ourselves to represent the entire committee.

Let me know what other information you need so we can get this moving!

G.

Dear Mr. Gittelman:

I am writing to introduce you to our firm and its services. We take the guesswork out of the bankruptcy process for you!

As an unsecured creditor of *Debtorco, Inc.*, you are probably wondering what we can do for you. Well, bankruptcy is a complicated and time consuming process for unsecured creditors, beginning with the formation of the Official Committee of Unsecured Creditors. Here's where we can help you. For a nominal fee of $15,000, we will attend the meeting for you (with your proxy), make sure that you get on the Committee and make sure that your professionals are appointed to the Committee. While we cannot guarantee a specific return on your claim, we can also solicit potential buyers for the claim for an additional broker's fee.

We have been performing this service for years in many jurisdictions and hope we can serve your needs. I look forward to hearing from you.

Very truly yours,

H.

(Sent nine days before Committee formation meeting):

Dear Creditors:

At the request of several creditors, **we have scheduled a conference call for tomorrow morning at 11:30 ET**. The purpose of this call is to provide a forum for creditors of [redacted] to share information, learn from other creditors and discuss goals to achieve in this case on behalf of unsecured creditors.

In addition, lawyers from [redacted] will participate on this phone call to answer any questions you may have and provide updated information, to the extent available. I have attached biographies of the [redacted] lawyers who will likely participate on tomorrow's call (for those of you who aren't familiar with us).

First day motions have been scheduled to be heard Friday morning at 9:30 am. First day motions include, the Debtors' request for authority to (i) use cash collateral of [redacted], (ii) jointly administer the cases, (iii) maintain existing cash management

system, (iv) pay prepetition wages and benefits, (v) pay prepetition sales taxes, (vi) honor certain customer obligations, deposits, rebates, (vii) provide adequate assurance to utilities, (viii) reject certain real property leases and (ix) establish procedures for interim compensation of professionals.

Dial-in information is as follows:

[redacted]

If you have any questions before or after the call, please do not hesitate to contact any one of us directly. [redacted] … our email addresses appear above.

We look forward to speaking with you … Sincerely, [redacted]

I.

(Sent one day before Committee formation meeting):

We know you have been bombarded with calls and emails from firms wanting to represent the Official Committee of Unsecured Creditors in [redacted] and we hesitate to add to that with this email.

We will take a moment because this case presents a challenge to unsecured creditors. [redacted] is proposing a quick store closing program and liquidation of the inventory in the majority of its lease locations with no indication of whether this fire sale of their assets will produce a recovery to unsecured creditors. Additionally, [redacted] is negotiating to hire a liquidation agent, [redacted], on a fee basis, without providing access to information regarding its assets to all potentially interested parties to encourage competitive bidding. We have been presented with similar situations in many other [redacted] cases and our experience shows that the Committee needs to establish a strong posture early in the case so that the Debtors' assets and its constituency's interests are not sold short.

The bankruptcy group of [redacted] has a renowned practice specializing in the representation of unsecured creditors' committees in out-of-court workouts and bankruptcies generally and, specifically, [redacted] cases. The firm recently represented many of the vendors in this case as counsel to the official creditors' committee of [redacted] in its chapter 11 bankruptcy case, which resulted in a sale of the assets to a private equity fund, an ongoing customer and

protection for the vendors from defending litigation regarding preferences. The firm also represented the unsecured creditors of [redacted] in a successful out-of-court restructuring, as well as the purchaser of substantially all of the assets of [redacted], [redacted] and [redacted], in their respective chapter 11 bankruptcy cases.

In addition, the firm has represented committees in hundreds of bankruptcies across the country in the past several years, in both cases big and small, including substantial department store cases in which many of the vendors from this case were involved, such as: [redacted].

Attached to this email is an Executive Summary we prepared outlining action items for the Committee and a [redacted] representative list of creditors' committee representations.

We look forward to the opportunity to meet with you tomorrow and discuss our qualifications to represent the Official Committee of Unsecured Creditors for [redacted]. In the meantime, if you have any questions regarding tomorrow's meeting or the case, please email or call us.

IV. Proxies

A. Role of Proxy Holders at Committee Formation Meetings

In some jurisdictions, a debtor's largest creditors are invited to attend the committee formation meeting in person. A creditor may choose to attend and participate in person or through a designated agent, known as a "proxy" or "proxy holder." For instance, the creditor might authorize the proxy to appear and speak on the creditor's behalf in an effort to be selected for the Committee, and if selected, to act on behalf of the creditor during the initial meeting of the Committee. This might include granting the proxy holder authority to vote for a chairperson of the Committee, to decide whether to interview professionals and whom to interview, to take a position or advise during the deliberations on the selection of professionals, and ultimately to cast the creditor's vote for one or more professional candidates to represent the Committee.

Proxy powers can be a beneficial way to facilitate and increase creditor participation at the committee formation meeting. However, they also have the potential to make the proxy holder, especially one with proxies from multiple creditors, a "kingmaker" at the formation meeting. If this kingmaker power was obtained through proxies that were unethically solicited, granted without authority, or exercised in a manner inconsistent with the grant, then it threatens the integrity of the committee.

Notwithstanding the great influence that proxy holders can have and the potential for abuse, it seems that relatively little has been written about the topic. That absence, however, will not excuse lawyers, financial advisors and others who act as proxies from complying with laws and duties applicable to this role.

B. Agency Law and the Duties of the Proxy Holder

A proxy is the grant of a power of attorney by one person to another. It is therefore governed by the law of agency. In the context of committee formation, the principal legal questions that arise are whether the proxy was duly authorized and executed and confers legitimate authority, whether the powers to be exercised by the proxy are sufficiently specified to confer the authority the proxy seeks to exercise, and what duties the proxy holder owes to the creditor in exercising the granted authority. Many questions from the first two categories can be answered from the face of the proxy document itself.

The duties in the third category include the duties of care, loyalty and candor of a fiduciary. See Restatement (Third) Agency §§ 8.01 – 8.12 (2006) (discussing fiduciary duties of an agent). The duty of candor should require that the proxy holder disclose to its principal any relationship the proxy holder has to professionals (lawyers, financial advisors) who may have played a role in connecting the proxy holder to the creditor. This is material information to the creditor. The duty of loyalty requires that the proxy holder's primary loyalty be to the creditor, not to serve the interests of professionals who seek committee engagement over the interests of the creditor. Finally, the duty of care imposes a duty to make decisions based upon an appropriate level of reasonable diligence.

In the context of a committee's selection of its professionals, the proxy holder can easily satisfy the duties of care, loyalty and candor if the creditor directs the proxy on which professionals to vote for. If there is broad discretion given to the proxy holder, however, the proxy holder may not act in a manner that is contrary to the duties to the principal. Even more of a concern would be taking action that rises to the level of a self-interested transaction, in which the proxy holder exercises discretion to choose a particular professional in an effort by the proxy holder to obtain some personal benefit from that choice. These issues should be a the forefront of a proxy holder's thinking when exercising the agency rights given by the creditor.

For a proxy holder who has been given discretion to select committee professionals, several practices are advisable. The proxy holder should disclose to the creditor the circumstances by which the proxy holder was referred to the creditor, and what connections exist between the proxy holder and any professional who seeks to be engaged by the committee. These discussions promote a clear and open process for creditors and may prepare the proxy holder to respond to questions about the legitimacy and scope of his authority under the proxy. In addition, the proxy holder could consult with the creditor to enable the creditor to make the decision rather than requiring the proxy holder to make a unilateral decision presuming how the creditor itself would have decided.

The duty of candor requires the proxy holder to have a detailed discussion with the creditor after the formation meeting and professional selection to disclose the material facts regarding the conduct of the meeting and the deliberation process. This is in keeping with the duty of candor, but it may be that this step is not often taken following committee formation meetings.

C. Rules of Professional Conduct Applicable to Lawyers Acting as Proxy Holders

In addition to the duties imposed under agency law, the proxy holder may be subject to professional or other ethical codes of conduct. Lawyers are subject to the form of the Model Rules of Professional Conduct (the "RPC") adopted in the relevant jurisdiction. Non-lawyers may be subject to ethical codes such as the guidelines promulgated by the Turnaround Management Association.

1. The general rule – Pure proxy representation is is not governed by RPC

As a general rule, holding a proxy does not subject the lawyer to the RPC because its is not the practice of law. A proxy holder is generally considered an *attorney in fact*.

Bankruptcy Rule 9010(a) supports this distinction between the act of holding and acting upon a proxy, versus engaging in the practice of law:

> Rule 9010. Representation and Appearances; Powers of Attorney
>
> (a) AUTHORITY TO ACT PERSONALLY OR BY ATTORNEY. A debtor, creditor, equity security holder, indenture trustee, committee or other party may (1) appear in a case under the Code and act either in his or its own behalf or by an attorney authorized to practice in the court, and (2) perform any act not constituting the practice of law, by an authorized agent, attorney in fact, or proxy.

The Official Forms promulgated pursuant to the Bankruptcy Rules also make this distinction, providing as follows:

> A power of attorney is an instrument that allows an individual, partnership, or corporation to authorize a specific individual to act as its agent or "attorney in fact" for certain matters. An "attorney in fact" is an agent who is appointed and authorized to act in place of another, as distinguished from an "attorney at law". A power of attorney does not authorize an individual to practice law and should not be confused with legal representation by an attorney, who is licensed by the state to engage in the practice of law.

http://www.uscourts.gov/bkforms/official/b11a-inst.pdf

2. Lawyer holding a proxy as "law-related services" under the RPC.

Even if holding a proxy does not constitute the practice of law, the attorney may nevertheless be subject to RPC if the proxy agency constitutes "law related services" within the meaning of Model Rule 5.7, which provides as follows:

> Rule 5.7 Responsibilities Regarding Law-Related Services
>
> (a) A lawyer shall be subject to the Rules of Professional Conduct with respect to the provision of law-related services, as defined in paragraph (b), if the law-related services are provided:
>
> (1) by the lawyer in circumstances that are not distinct from the lawyer's provision of legal services to clients; or
>
> (2) in other circumstances by an entity controlled by the lawyer individually or with others if the lawyer fails to take reasonable measures to assure that a person obtaining the law-related services knows that the services are not legal services and that the protections of the client-lawyer relationship do not exist.
>
> (b) The term "law-related services" denotes services that might reasonably be performed in conjunction with and in substance are related to the provision of legal services, and that are not prohibited as unauthorized practice of law when provided by a nonlawyer.

A threshold question is whether holding a proxy at a committee formation meeting may be considered "law-related services". The conservative approach suggests that it is. To a creditor, the bankruptcy case is inherently a legal process. If the creditor is an entity (as opposed to an individual), it knows or should know that it would need legal representation in connection with the bankruptcy case. The formation meeting itself, though not conducted by the bankruptcy court, can itself easily be perceived as part of the legal process of the bankruptcy case itself.

A lawyer holding a proxy is subject to <u>all</u> provisions of the RPC when either section 5.7(a)(1) or 5.7(a)(2) is satisfied. If the proxy holding lawyer provides any "legal services" to the creditor in connection with the services of holding the proxy, then all actions as the proxy holder are also imbued with the full complement of ethical rules. It can be argued that almost any advice a proxy holder gives to the creditor would be considered legal advice so as to invoke section 5.7(a)(1). On one hand, a non-lawyer who is experienced in the committee formation process can act as a principal for a creditor, as proxy holder, and provide some level of advice on the workings of the process. When a lawyer provides similar advice, it would be hard to argue that the lawyer is not providing <u>legal</u> advice. An analogy could be with a creditor sitting in a courtroom watching a confirmation hearing, with its financial advisor and lawyer. If there is a pending offer for the creditor's claim that begins to look far more valuable as the confirmation hearing progresses, and both the advisor and lawyer each lean over to the creditor and recommend that it sell its claim, it is most likely the case that the lawyer has provided legal advice while the advisor has not.

To avoid the section 5.7(a)(1) result, a lawyer holding a proxy must not give advice involving legal analysis. The lawyer should limit himself to acting as a mere agent caring out the intentions of the creditor. If the lawyer seeks to influence the creditor's intentions, the lawyer risks crossing over into a full-blown lawyer-client relationship with the creditor.

Section 5.7(a)(2) may apply if a lawyer recruits a non-lawyer to hold a proxy. This subsection applies if the non-lawyer is "controlled" by the lawyer "individually or with others". If the "control" test is met, then the lawyer will be deemed to have established a full lawyer-client relationship with the creditor even though he or she is not actually providing any legal services, and a third party is performing the proxy services.

A lawyer who suggests to a creditor that he or she can represent the creditor by proxy at the meeting may be deemed to instill in the creditor a reasonable perception that the lawyer will be acting as a lawyer while holding the proxy, as opposed to a mere agent. This too invokes triggers 5.7(a)(2).

V. Second Hypothetical – Proxy Solicitation

Jones is an accountant and turnaround consultant who likes to represent creditors committees. Jones has excellent telephone skills and is the type of person that can "schmooze" her way in to dinner at the White House. Jones knows how to develop a relationship with a creditor in one phone call. She knows enough to tell the creditor to file a reclamation demand. She knows enough to tell the creditor where and how to file a proof of claim. She understands about critical vendor motions and preference exposure. Jones will call up the creditors on the "top twenty" list and talk about the case with each creditor who will take Jones' call. Topics may include such issues as the speed of a "363" sale that the debtor contemplates, the likely dividend for creditors, what needs to be investigated in the case, etc. Jones can casually inquire as to whether the creditor is represented by counsel or if the creditor is unrepresented. If the creditor has no independent counsel and has no one in mind for committee counsel, then Jones also will inquire as to whether the creditor intends to come to the committee formation meeting. If the creditor says that it prefers not to travel to the meeting (or cannot attend), but wants to serve on the committee, then Jones will offer to "attend" on the creditor's behalf without charge. If the creditor gives Jones a proxy, then Jones will go to the committee formation meeting and try to get the creditor on to the committee. Jones does not explicitly tell the creditor that Jones will use the proxy to vote for counsel of her choosing.

> Is it ethical and appropriate for Ms. Jones to make the telephone calls to the "top twenty" creditors for the purpose of obtaining proxies that Jones can use to get an attorney friend of Jones elected as committee counsel?

A. First Variation to Hypothetical Scenario

Attorney Smith sees that a new chapter 11 case has been commenced in Wilmington. Smith reviews the list of the top twenty unsecured creditors and does not know anyone on the list. None of the creditors seem to be clients of his firm, but Smith

would still like to find a way to become counsel to the committee. Smith does not want to make cold calls to the creditors himself, so he calls a friend of his (Ms. Jones) who is a financial advisor and who understands the world of bankruptcy.

> Is it ethical and appropriate for Smith to ask Jones to make the telephone calls for the purpose of ascertaining which creditors are represented by counsel and which creditors may be willing to give a proxy to someone in order to "attend" the committee formation meeting on the creditor's behalf? Smith would like Jones to hold the proxy and be in the room when the committee is voting for counsel.

Smith would like Jones to steer some creditors to Smith. Smith would like Jones to say that some creditors that "Smith is the guy to call since he knows a lot about the case. You should give him a call." Or, perhaps, "Do you want me to have Smith call you since he's very familiar with the case?"

> Is it okay for Smith to ask Jones to suggest/recommend/urge the creditor to call Smith? Is it okay for Smith to call the creditor if Jones tells Smith that the creditor said that Smith should call?

B. Second Variation to Hypothetical Scenario

Attorney Smith sees that a new chapter 11 case has been commenced in Wilmington. Smith reviews the list of the top twenty unsecured creditors and does not know anyone on the list. None of the creditors seem to be clients of his firm, but Smith still would like to find a way to become counsel to the committee. Smith calls a friend of his (Ms. Williams) who understands the world of bankruptcy. Williams has excellent telephone skills and is the type of person that can "schmooze" her way in to dinner at the White House. Williams knows how to develop a relationship with a creditor in one phone call. She knows enough to tell the creditor to file a reclamation demand. She knows enough to tell the creditor where and how to file a proof of claim. She understands critical vendor motions and preference exposure. Williams will call up the creditors on the top twenty list and talk about the case with each creditor who will take Williams' call. Topics may include such issues as the speed of a "363" sale that the debtor contemplates, the likely dividend for creditors, what needs to be investigated in the case, etc. Williams can casually inquire as to whether the creditor is represented by counsel or if the creditor is unrepresented. If the creditor has no independent counsel and has no one in mind for committee counsel, then Williams also will inquire as to whether the creditor intends to come to the committee formation meeting. If the creditor says that it prefers not to travel to the meeting (or cannot attend), but wants to serve on the committee, then Williams will offer to "attend" on the creditor's behalf without charge. If the creditor gives Williams a proxy, then Williams will go to the committee formation meeting and try to get the creditor on to the committee. Smith would like Jones to hold the proxy and be in the room when the committee is voting for counsel. It is not explicitly said to the creditor that Williams will use the proxy to vote for counsel and a financial advisor of Williams' choosing. Williams is not a bankruptcy professional (accountant or financial advisor), but Williams would like to become the disbursing

agent, liquidation trustee or litigation trustee at the end of the case. It is understood that Smith will push the committee for Williams to be appointed to that role at the end of the case if Williams can help Smith become committee counsel.

> Is it ethical and appropriate for Williams to make the telephone calls to the "top twenty" creditors for the purpose of obtaining proxies that Williams can use in order to get Smith elected as committee counsel?
>
> Is it ethical and appropriate for Smith to ask Williams to make the telephone calls for the purpose of Williams ascertaining which creditors may be willing to give a proxy to Williams to attend the committee formation meeting (and vote for Smith as counsel)?
>
> Is it ethical and appropriate for Smith to ask Williams to make the telephone calls for the purpose of Williams ascertaining which creditors are represented by counsel and, if so, the identity of counsel? Smith would like to obtain that information in order to, among other things, make contact with counsel and attempt to obtain the support of the attorney's client.