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"Ethical Considerations in Distress"

Selected Issues for Ad Hoc Groups

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What is An Ad Hoc Group?

- “Ad hoc group” typically refers to an unofficial affiliation of holders of the same type of claims or interests.
- They often hire joint advisors and may take positions as a group in negotiations or in court.
- Ad hoc groups usually do not adopt formal rules or bylaws.
- Membership can be volatile since parties are free to trade their positions or withdraw from the group, and new participants may be added at any time. Groups sometimes splinter due to cross-holdings.
- Members of the group usually bear the costs of the group’s legal and other professional expenses. Outside of a bankruptcy case, an ad hoc group may negotiate to have its fees paid by the borrower (although if the company files, the fees might be subject to avoidance).
- There is precedent in the chapter 11 context for payment of an ad hoc group’s legal expenses by the estate as adequate protection (*e.g.*, *Lyondell*) or under a plan of reorganization (*e.g.*, *Adelphia*). Section 503(b)(3)- (4) of the Bankruptcy Code also permits creditors and non-statutory creditor committees to assert claims for reimbursement based on “substantial contribution in a case.”

Ad Hoc Group Issues

- Ad hoc groups and their counsel may confront a variety of ethical, legal, and other issues, which can emanate from:
  - Exposure to material non-public information
  - Differing interests and potentially conflicting agendas among group members
  - Certain disclosure obligations not required of similarly situated parties outside the group
  - Potential duties to other creditors or interest holders
  - Potential legal and reputational risks arising from group conduct
  - Ethical issues related to joint representation
  - Remedies for unethical conduct

The Rise of Plan Mediation

- Plan mediation is increasingly common in large and complex cases; it has the potential to lead to settlement, but it can also increase costs and foster delay.
  - Several factors help determine whether mediation will be successful, including: (i) credibility and effectiveness of the mediator, (ii) timing in the case, (iii) identity of active stakeholders and (iv) the focus of the mediation.
  - Access to material non-public information ("MNPI") is a particular challenge for holders who seek to participate in mediation while maintaining the ability to trade, especially in the wake of Judge Walrath's decision in the *Washington Mutual* case.
  - Possible approaches range from strict restriction, as in the *General Motors* cases, to broad exculpations, as in the *Cengage Learning* cases.

WaMu – The Dangers of Exposure to MNPI during Mediation

In re Washington Mutual, Inc., 461 B.R. 200 (Bankr. D. Del. 2011)

CASE BACKGROUND AND NEGOTIATIONS

- Case Background: Washington Mutual, Inc. ("WaMu") filed a chapter 11 case on September 26, 2008 after a steep decline in revenues and credit rating downgrades led banking regulators to place WaMu's main operating subsidiary into receivership.
  - The primary driver of value in the case was a dispute with JPMorgan over ownership of certain assets.
  - Early in the case, investors took large positions in the WaMu capital structure, including blocking positions in two classes of senior and subordinated debt (the "Settlement Noteholders").
  - Eventually a global settlement was reached regarding ownership of the disputed assets.
- Settlement Negotiations: The Settlement Noteholders participated in negotiations directly and through counsel, necessitating the establishment of procedures to manage MNPI:
  - Formal "lockup periods" and ethical walls were put in place, with any MNPI received by the Settlement Noteholders being disclosed at the end of each lockup period.
  - Counsel also continued discussions, but did not provide updates to their clients to allow trading outside the lockup periods.
- Equityholders' Challenge: The official committee of equityholders (the "Equityholders") argued that the Settlement Noteholders traded on MNPI related to the negotiations, including term sheets and negotiating positions relayed by counsel, and sought standing to bring insider trading–based claims against the Settlement Noteholders on WaMu's behalf.

WaMu – The Dangers of Exposure to MNPI during Mediation

CASE BACKGROUND AND NEGOTIATIONS (Cont.)

- Judge Walrath found the Equityholders' insider trading allegations colorable, and allowed the Equityholders to engage in an investigation and litigation over potentially disallowing or subordinating the Settlement Noteholders' claims. Key findings included:
  - That information regarding ranges of settlement and settlement negotiations could be considered material even when a settlement was not imminent and regardless of whether the settlement eventually fell through.
  - That the Settlement Noteholders may have become "temporary insiders," or alternatively, non-statutory insiders under the Bankruptcy Code, by reason of their special relationship with and enhanced access to the Debtor.
  - That the Settlement Noteholders were not entitled to rely on the Debtor's disclosures—they bore the onus of ensuring proper disclosure before trading.
- Although Judge Walrath subsequently vacated key parts of the WaMu decision as required by a later settlement, and the decision did not resolve the merits of the Equityholders' claims, it nonetheless highlights the risks for creditors who may want, or be required, to participate in mediations that may require exposure to MNPI.

Potential Solutions to the MNPI Problem in Plan Mediation

Information Walls: The WaMu mediation order, like others, provided for limitations on information sharing between counsel and representative parties (like trustees and agents) on the one hand and beneficial holders on the other. Certain participants also established internal information walls to preserve their freedom to trade.

- Information walls can be an imperfect solution and may be impractical for smaller holders.

Cleansing Disclosure: Present in WaMu, cleansing disclosure is only as effective as the information disclosed, thus materiality judgments are key to avoiding liability.

- Conservative mediation participants will require full disclosure of all shared non-public information.
- Extensive cleansing may force companies to disclose sensitive information.
- Market participants are increasingly demanding broad cleansing of virtually all information shared to reduce the risk that a materiality judgment might be second-guessed.

Going Restricted: A conservative solution, but with numerous drawbacks. Indefinite lock-up periods may create a challenge for investors that value liquidity. Discrete restricted periods as in WaMu are also not a panacea, given MNPI-related risk in the absence of extensive, and possibly problematic, disclosure.

- Note that indefinite restriction, while onerous, appears to be Judge Walrath's favored solution in the WaMu ruling.

GM and *Cengage*: Differing Approaches to the MNPI Problem in Plan Mediation

<u>The GM Order</u>: A mediation order in the *General Motors* case ("GM" and the "GM Order") explicitly spelled out the risks of participation and afforded parties no protection from the effects of exposure to MNPI:

- Each party was required to acknowledge that they might receive MNPI in connection with the mediation and the potential for liability, including claim subordination.
- Private-side counsel could only share information with a designated "party representative" or upon investors' execution of strict confidentiality agreements.

<u>The Cengage Order</u>: The mediation order in *Cengage* (the "Cengage Order") included language purporting to insulate investors from concerns regarding exposure to MNPI, including:

- A finding that "[a]ll settlement proposals, counterproposals, and offers of compromise made during the mediations sessions . . . shall not constitute material nonpublic information."
- A provision that "No Party shall (a) be or become an insider . . . , (b) be deemed to owe any duty to any Debtor Parties . . . , (c) undertake any duty to any party in interest, or (d) be deemed to misappropriate any information . . . ."
- Limitation of equitable subordination risk: "No party in interest . . . shall have . . . any other basis to withhold, subordinate, disallow or relay payment . . . on account of a claim based on such Party's trading in Debtor Party Securities by reason of a Party's participation in the Mediation as a result of receiving . . . (b) a Settlement Proposal . . . "

<u>LightSquared Order</u>: The *Cengage* provisions were incorporated in an order entered by Judge Chapman in late May.

Pre-filing Considerations

- More and more chapter 11 cases are getting resolved pre-filing under restructuring support agreements.
- Negotiating MNPI issues are even more difficult during pre-filing negotiations as there is no consistent outlet for public disclosure other than through SEC filings.
- This often leads to negotiations between parties having limited visibility into issues that the borrower will not agree to make public in a non-bankruptcy setting.

When Does An Ad Hoc Group Owe Duties to Others?

- Most ad hoc groups profess to represent their members' own interests, which may or may not be aligned with the interests of other holders of the same class of claims or interests.
- Courts traditionally recognized the right of ad hoc group members to act in their own self-interest (*see, e.g., In re Drexel Burnham Lambert Group*, 123 B.R. 702, 706 (Bankr. S.D.N.Y. 1991) (holding ad hoc groups do not have fiduciary duties like members of official committees).
- However, more recently, some bankruptcy courts have suggested that ad hoc groups may owe fiduciary duties to other creditors under certain circumstances.
- Whether ad hoc groups owe fiduciary duties is an issue that has arisen in the context of courts' analysis of the applicability of Bankruptcy Rule 2019, which requires entities or committees representing more than one creditor or equity security holder to disclose certain information.
- The bankruptcy court decisions in *Mirant*, *Northwest Airlines* and *WaMu* provide insight into why some courts have favored heightened disclosure obligations and have suggested that ad hoc groups may have duties to others under some circumstances.

Official Comm. of Equity Security Holders v. Wilson Law Firm, P.C. (In re Mirant Corp.), 334 B.R. 787 (Bankr. N.D. Tex. 2005)

- Debtors filed a chapter 11 plan that was supported by two official committees of unsecured creditors and the official committee of equity security holders appointed by the U.S. Trustee.
- The Court approved the Debtors' disclosure statement and authorized the Debtors to include in the solicitation package certain court-approved letters from each of the official committees.
- A law firm purporting to represent an ad hoc group of shareholders sent emails to shareholders and posted statements on its website advocating that shareholders reject the plan.
- The official committee of equity holders and a court-appointed examiner moved for a preliminary injunction to prevent the firm from disseminating its statements, arguing that they included materially misleading and inaccurate statements about the plan, the disclosure statement, and the rights of voting creditors and shareholders.

(Mirant Corp. Cont.)

- The Bankruptcy Court agreed with the movants and issued a preliminary injunction, holding that "by participating in these cases as a representative of shareholders, **by assuming the role on the Firm's website of counsel to an 'ad hoc committee,'** by seeking compensation for the Firm from the estate, [the lawyer] has assumed the responsibilities and duties of a fiduciary in these cases and owes it to the constituency he purports to represent—here the common stockholders—to present only truthful and accurate information in the Solicitation Materials."
- The Court commented that "when a party purports to act for the benefit of a class, the party assumes a fiduciary role as to the class."
- Although the Court focused on the conduct of the firm rather than its clients (which apparently had not reviewed or approved the materials disseminated by the firm), the Court's reasoning suggests that an ad hoc committee purporting to represent the interests of a broader group assumes fiduciary duties to that group.

In re Northwest Airlines Corp., 363 B.R. 701 and 363 B.R. 704 (Bankr. S.D.N.Y. 2007)

- Debtor moved to compel ad hoc group of equity holders to supplement their counsel's Rule 2019 Statement to comply with the rule.
- Ad hoc group argued it was not a "committee" within the meaning of the Rule.
- Bankruptcy Court agreed with the debtor and ordered compliance with Rule 2019.
- In doing so, the Bankruptcy Court reasoned that **"[b]y appearing as a 'committee' of shareholders, the members purport to speak for a group and implicitly ask the court and other parties to give their positions a degree of credibility appropriate to a unified group with large holdings."**
- The Equity Committee thereafter requested that the Court allow them to file their Rule 2019 Statement under seal, arguing that it had not taken on the role of fiduciary and was entitled to protection of its proprietary trading information.

(Northwest Airlines Cont.)

- The Court denied that request, finding that the need to provide other interested parties access to the disclosure outweighed the members' desire to keep their trading information confidential.
- The Court commented that "this Committee purports to control 27 percent of the outstanding stock of the Debtors and . . . has repeatedly asked the Court to give credibility to its claims that the Debtors' equity has substantial value, that the Debtors' management has wrongfully undervalued equity, and that it intends to mount a contest as to the valuation . . . . [T]heir negotiating decisions as a Committee should be based on the interests of the entire shareholders' group, not their individual financial advantage."
- The Court acknowledged that the ad hoc group disclaimed having any fiduciary responsibilities to the shareholders as a group. However, the Court still found that members had assumed the obligation to comply with Rule 2019: "**[a]ssuming, *arguendo*, for purposes of this motion that the Committee does not act as a fiduciary, Rule 2019 is based on the premise that the other shareholders have a right to information as to the Committee member purchases and sales so that they make an informed decision whether this Committee will represent their interests or whether they should consider forming a more broadly-based committee of their own. It also gives all parties a better ability to gauge the credibility of an important group that has chosen to appear in a bankruptcy case and play a major role."**

In re Washington Mutual, Inc., 419 B.R. 271 (Bankr. D. Del. 2009)

- Early in the case, counsel for a group of 23 noteholders (the "WMI Noteholders Group") filed an appearance and a Rule 2019 Statement listing the names and addresses of the members and disclosing that their collective holdings were in excess of $1.1 billion.
- The 2019 Statement represented that each entity "participating in the WMI Noteholders Group makes its own decisions as to how it wishes to proceed and does not speak for, or on behalf of, any other creditor, including the other participants participating in the WMI Noteholders Group in their individual capacities."
- Acting through counsel, the group filed responses in several contested matters and took positions at numerous hearings during the case.
- JP Morgan (acquirer of most of the bank assets) moved to compel the WMI Noteholders Group to comply with Rule 2019, arguing that the limited disclosures by the group's counsel were inadequate.

(Washington Mutual Cont.)

- The WMI Noteholders Group argued that it was not an "entity or committee representing more than one creditor," but merely a "loose affiliation of creditors who, in the interests of efficiency are sharing the cost of advisory services in connection with the case."
- The Bankruptcy Court found that the plain language of Rule 2019 required the WMI Noteholders Group to comply.
- The Court rejected the WMI Noteholders Group's argument that Rule 2019 only applies to "a body that purports to speak on behalf of an entire class or broader group of stakeholders in a fiduciary capacity with the power to bind stakeholders that are members of such a committee."
- In doing so, the Court noted there is case law suggesting that "members of a class of creditors may, in fact, owe fiduciary duties to other members of the class."
- The Court found that while it was unnecessary to determine "the precise extent of fiduciary duties owed" by the WMI Noteholders Group, "collective action by creditors in a class implies some obligation to other members of that class."

Ethical and Legal Issues for Group Counsel

- Overview
- Joint Representation and the New York Rules of Professional Conduct
- Terms of Engagement – Best Practices

Overview

- Ad hoc groups often retain group counsel to provide legal advice and/or represent the group in negotiations and in court.
- An obvious advantage of hiring group counsel is the opportunity to divide legal expenses among several creditors with the same type of credit exposure and at least some common goals.
- Group representation also carries certain limitations and raises potential ethical issues. For example:
  - To comply with applicable ethics rules, counsel will likely require advance waivers and acknowledgments from each client that would not be required for an individual representation.
  - If group members disagree on strategy or positions, ethical issues may arise for group counsel, and clients may find they need to hire their own separate counsel on some issues.
- Issues of confidentiality and attorney-client privilege can be challenging, particularly when group membership changes.

Joint Representation and the New York Rules of Professional Conduct

- **Differing Interests Among Clients:**

  NY Rule of Professional Conduct 1.7 provides:

  *(a) Except as provided in paragraph (b), a lawyer shall not represent a client if a reasonable lawyer would conclude that…*the representation will involve the lawyer in representing differing interests[.]

  (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

  > (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
  >
  > (2) the representation is not prohibited by law;
  >
  > (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
  >
  > (4) each affected client gives informed consent, confirmed in writing.

Joint Representation and the New York Rules of Professional Conduct

- Official Comments to Rule 1.7:
  - “If a conflict arises after representation has been undertaken, the lawyer ordinarily must withdraw from the representation unless the lawyer has obtained the informed consent of the client under the conditions of paragraph (b).”
  - “Unforeseeable developments, such as changes in corporate and other organizational affiliations or the addition or realignment of parties in litigation, might create conflicts in the midst of a representation, as when a company sued by the lawyer on behalf of one client is acquired by another client represented by the lawyer in an unrelated matter. Depending on the circumstances, the lawyer may have the option to withdraw from one of the representations in order to avoid the conflict.”
  - “[T]he professional judgment of a lawyer asked to represent several individuals operating a joint venture is likely to be adversely affected to the extent that the lawyer is unable to recommend or advocate all possible positions that each client might take because of the lawyer’s duty of loyalty to the others.“

Joint Representation and the New York Rules of Professional Conduct

- Official Comments to Rule 1.7 (cont.):
  - "A particularly important factor in determining the appropriateness of common representation is the effect on client-lawyer confidentiality and the attorney-client privilege. With regard to the attorney-client privilege, the prevailing rule is that, as between commonly represented clients, the privilege does not attach. It must therefore be assumed that if litigation eventuates between the clients, the privilege will not protect any such communications, and the clients should be so advised."
  - "As to the duty of confidentiality, continued common representation will almost certainly be inadequate if one client asks the lawyer not to disclose to the other client information relevant to the common representation. This is so because the lawyer has an equal duty of loyalty to each client, and each client has the right to be informed of anything bearing on the representation that might affect that client's interests and the right to expect that the lawyer will use that information to that client's benefit. At the outset of the common representation and as part of the process of obtaining each client's informed consent, the lawyer should advise each client that information will be shared and that the lawyer will have to withdraw if one client decides that some matter material to the representation should be kept from the other. In limited circumstances, it may be appropriate for the lawyer to proceed with the representation when the clients have agreed, after being properly informed, that the lawyer will keep certain information confidential even as among the commonly represented clients."

Joint Representation and the New York Rules of Professional Conduct

- **Allocation of Authority Between Client and Lawyer:**

  NY Rule of Professional Conduct 1.2 (a) provides:

  (a) Subject to the provisions herein, a lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued. A lawyer shall abide by a client's decision whether to settle a matter.

  Official Comments to Rule 1.2:

  "Paragraph (a) confers upon the client the ultimate authority to determine the purposes to be served by legal representation, within the limits imposed by law and the lawyer's professional obligations. The decisions specified in paragraph (a), such as whether to settle a civil matter, must also be made by the client."

  "Where the client is a fiduciary, the lawyer may be charged with special obligations in dealings with a beneficiary."

Joint Representation and the New York Rules of Professional Conduct

- **<u>Settlement of Claims</u>:**

NY Rule of Professional Conduct 1.8(g) provides:

(g) A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, absent court approval, unless each client gives informed consent in a writing signed by the client. The lawyer's disclosure shall include the existence and nature of all the claims involved and of the participation of each person in the settlement.

Official Comments to Rule 1.8:

"Differences in willingness to make or accept an offer of settlement are among the risks of common representation of multiple clients by a single lawyer…. Paragraph (g) is a corollary of both these Rules and provides that, before any settlement offer is made or accepted on behalf of multiple clients, the lawyer must inform each of them about all the material terms of the settlement, including what the other clients will receive or pay if the settlement is accepted."

Joint Representation and the New York Rules of Professional Conduct

- **Potential for Conflicts of Interest Among Members:**

NY Rule of Professional Conduct 1.9(a) provides:

A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.

Official Comments to Rule 1.9:

"Nor could a lawyer who has represented multiple clients in a matter represent one of the clients against the others in the same or a substantially related matter after a dispute arose among the clients in that matter, unless all affected clients give informed consent."

Joint Representation and the New York Rules of Professional Conduct

- **<u>Potential Issues With Respect to Obligation to Withdraw as Counsel if Disputes Arise Among Members</u>:**

NY Rule of Professional Conduct 1.16 (b)(1) provides:

"[A] lawyer shall withdraw from the representation of a client when…the lawyer knows or reasonably should know that the representation will result in a violation of these Rules or of law[.]"

Terms of Engagement
Best Practices

- Group counsel should include in its engagement letter(s) appropriate disclosures and obtain written consent from each member with respect to any advance waivers required for the effective representation of the group.

- Consider the following possible terms of engagement for group counsel:
  - Counsel should disclose/client should acknowledge joint representation, unless client is the group and not its individual members
  - Counsel should disclose/client should acknowledge and consider potential for future conflict

Terms of Engagement – *Best Practices (Cont.)*

- Although it would be helpful for group members to disclose all of their positions (including direct exposure, short positions and derivative exposure) to each other at the outset of the representation, it is unlikely that all group members will agree to share that information.

Terms of Engagement – *Best Practices (Cont.)*

- o Counsel should obtain waiver of future conflicts and consent to counsel's partial withdrawal and continued representation of other group members.
  - Group members should be mindful of the risk that some members may withdraw from the group or counsel may "drop" some clients if disputes arise within the group.
- o Counsel should disclose/client should consider possible limitations on attorney-client privilege.
- o Counsel should encourage client to seek independent advice in deciding whether to accept the terms of the joint engagement.

Remedies for Unethical Conduct

- Equitable Subordination
- Vote Designation

Remedies for Unethical Conduct
Equitable Subordination

- Under section 510(c) of the Bankruptcy Code, claims can be equitably subordinated to a position behind general unsecured claims, sending those claims to the "back of the line."
- Generally requires: (i) inequitable conduct; (ii) resulting in injury to the creditors or an unfair advantage on the claimant, and (iii) that equitable subordination must not be inconsistent with the provisions of federal bankruptcy law.
- Unlike recharacterization, equitable subordination looks to whether the creditor engaged in misconduct, in which case the creditor's claims are subordinated so as to remedy the harm suffered by the debtor's other creditors as a result of that misconduct.
- Equitable subordination also differs from recharacterization insofar as it recognizes the existence of an otherwise valid debt, but subordinates that debt to a position below (other) unsecured claims.

Remedies for Unethical Conduct
Vote Designation

- Section 1126(e) of the Bankruptcy Code vests bankruptcy courts with discretionary authority to "designate" votes on a plan of reorganization when such votes were not acquired or cast in good faith.
- Designation disputes are very fact dependent, but a creditor that purchases claims for the sole or primary purpose of blocking acceptance of a plan of reorganization will generally not be found to have acted in bad faith.
- Nonetheless, there are certain types of creditor conduct related to such purchases that can lead a court to conclude that the purchasing creditor acted in bad faith.
  - In particular, creditors that have ulterior motives—such as seeking to assume control of the debtor or affiliating with one of the debtor's competitors—may be found to have acted in bad faith.
- Similarly, creditors seeking to destroy the debtor out of pure malice or manipulate the voting process so as to achieve an advantage over other similarly situated creditors may have their votes designated by the court.

Additional Ethical Considerations

- If your clients have requested that you do not disclose any MNPI to them that you acquire through their representation, but you know your clients are about to make a bad investment without such MNPI, do you have a duty to disclose?
- Distressed investors and private equity funds commonly sit on boards of directors. What are the ramifications, if any, of such relationships?
- Is it ethical to leak stories to news outlets?
- How/should you withdraw if your client decides to employ a scorched earth strategy?
- Does the nature of distressed investing encourage some unethical behavior?