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Bankruptcy Court Slams U.S. Trustee's Attempted Disqualification of Investment Banker

By Michael L. Cook*

In this article, the author dissects a recent bankruptcy court decision that, he writes, shows how investment bankers can and do add value in reorganization cases.

The "connections" of the chair ("W") of the debtor's investment bank ("S") to his family's foundations do "not give rise to an actual, active conflict of any kind," held a bankruptcy judge in the U.S. District Court for the Southern District of New York.

According to the court's recent decision in *In re SAS A.B.*,[1] it "is only through strained speculation [by the U.S. Trustee] that a potential issue can even be posited."[2]

Courts routinely rely upon "ethical walls," said the court, when "large investment banking firms have affiliates or divisions that engage in debt trading, stock trading, or other activities that arguably might give rise to potential issues if a person engaged in those activities were permitted to communicate with the investment bankers." Because the U.S. Trustee ("UST") had "endorsed the use of ethical walls . . . in a countless number of [other cases]," the court saw "no reason why such arrangements would not be sufficient to protect against any risks that one might posit with respect to [W's] association with" his family foundations.

The court then approved S's wall in the case.

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[1] *In re SAS A.B.*, 2022 Bankr. LEXIS 2946 (Bankr. S.D.N.Y. Oct. 17, 2022).

[2] *Accord, In re Harold & Williams Dev. Co.*, 977 F.2d 906 (4th Cir. 1992) (rejected UST and bankruptcy court's per se prohibition of professional's serving as attorney and accountant; "horrible imaginings alone cannot be allowed to carry the day"; remanded for fact-specific inquiry whether foreseeable tasks presented inherent conflict or potential breach of confidence); *quoting In re Martin*, 817 F.2d 175, 183 (1st Cir. 1987) (same; "Not every conceivable conflict must result in" disqualification).

RELEVANCE

Every professional seeking retention in a bankruptcy case must file a "verified statement . . . setting forth 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."[3] The professional's retention under Bankruptcy Code ("Code") Section 327(a) thus requires disclosure of any information bearing on the court's consideration of Section 327(a)'s two-prong test (disinterestedness and no adverse interest). The professional's disclosure must be "spontaneous, timely and complete."[4] Failure to disclose relevant information is itself ground for reduction of fees or removal from the case.[5]

FACTS

The debtors sought to retain "S" as a co-investment banker. The UST argued that S was "not 'disinterested' and therefore not eligible to be employed as the Debtors' investment banker [under] the terms of [Code] §§ 101(14) and 327. . . ."

S "is a commercial and investment bank with operations in Scandinavia" and "has acted as both a commercial bank and as an investment banker to the Debtors in connection with many transactions. . . ." The debtor's business plan "will require new capital raises and debt-to-equity conversions." Because the relevant Scandinavian governmental entities "are stakeholders in the Debtors, and many of the Debtors' other creditors and parties of interest are located in Scandinavia," the debtors claimed to have needed "an investment banker with experience and contacts in Scandinavia," making S "well-suited" (perhaps uniquely suited) to provide the necessary services."

No party had challenged S's qualifications, but only the UST claimed that S was not "disinterested" as required by Code Sections 327 and 101(14). Section 327 permits the employment of professional advisors who are "disinterested persons," while Section 101(14) provides that term to exclude those who,

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[3] Fed. R. Bankr. P. 2014(a).

[4] *Rome v. Braunstein*, 19 F.3d 54, 59 (1st Cir. 1994).

[5] *In re Textile Indus., Inc.*, 198 B.R. 902, 905 (Bankr. M.D.N.C. 1996) (accountant holding previously undisclosed pre-bankruptcy claim against debtor immediately removed from case); *In re Filene's Basement, Inc.*, 239 B.R. 850, 858 (Bankr. D. Mass. 1999) (law firm having a definite adverse interest removed from case because it "failed fully to disclose its connections with parties in interest [i.e. litigation targets] as required by Rule 2014").

among other things, were "a creditor, . . . equity security holder, or an insider," or who have an interest "materially" adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, or connection with, or interest in, the debtor, or for any other reason." According to the UST, S had "a number of 'connections' . . . that raised 'disinterestedness' issues that should disqualify [it] from acting as an interest banker in these cases."

DISINTERESTEDNESS

The Chair's Family Foundations

The family of the chair of S's board of directors, W, is associated with sixteen private foundations ("Foundations"). The Foundations owned an entity known as "W Investments" that also owns 3.42% of the debtor's common stock, worth "approximately $13.2 million, compared to total assets of the Foundations in excess of $24.3 billion." The Debtors made full disclosure "in ample time to permit the [UST] or other parties in interest to file objections." But the UST argued here that W's "association with the Foundations could create conflicts of interest for [S]."

For example, reasoned the UST, the Foundations' interests "might cause" S "to favor equity interests of the kind that" the Foundations indirectly own "or might prompt W to issue instructions that the investment bankers do so." The court rejected UST's hypothetical and theoretical fears, explaining that "the question to be decided . . . is whether a given set of facts gives rise to a bias against the estate or to an economic interest that actually has a significant potential to affect the professional's loyalty, to undercut the value of the professional's services, or to give rise to a dispute in which the estate would be a rival party."[6]

The court "simply [could not] see how [W's] connection to the Foundations gives rise to a 'materially adverse interest' under these standards," stressing the following indisputable facts.

- Neither W nor S itself owned any stock in the debtor;
- W is associated with the Foundations, but had no personal interest in the investments of the assets of the Foundations and S itself had no such interests;
- The Foundations' indirect "small equity stake" in the debtors "is just a tiny fraction of the overall asset of the Foundations and is not material

[6] *In re SAS A.B.*, *supra* n.1, *citing In re Arochem Corp.*, 176 F.3d 610, 623 (2d Cir. 1999).

to the Foundations";

- W has "no day-to-day involvement with the [S] investment banker teams" working on the proposed engagement;
- S is not the sole investment banker, but is a co-investment banker with another admittedly disinterested entity and W has no "interest [in] or control over" that entity;
- S will "bar communications between [W] and the investment bankers;" and
- W "will not participate in any discussions or votes at directors' meetings of the Foundations that in any way pertain to the Debtors."

The court rejected the UST's position that the "ethical walls" here were insufficient as a matter of law, as noted earlier. In any event, the court required that the S investment banking team "have no communications with [W], the . . . Foundations, [and] other groups [within S] and individuals associated with any of those entities or groups about [S's] work for the Debtors and about any non-public information that the investment banking team has about the Debtors." These protections, said the court, make it "quite clear that [W's] association with the . . . Foundations, and the . . . Foundations' indirect ownership of a small portion of [the debtor's] outstanding equity, do not raise a disqualifying 'materially adverse interest' as to [S's] retention as co-investment banker."

Other Makeweight Assertions Rejected

The court also rejected the UST's other similar arguments as "far too attenuated" to be disqualifying. Because of the "ethical wall" applied above, the court rejected a challenge to S's pre-bankruptcy sale of an interest in outstanding Debtor loans because the UST made no showing that "the Debtors made recoverable transfers in connection with" the sale of S's interests. As to the UST's assertion that S "might be a logical entity to approach for exit financing," the court again stressed that "the speculative loss of a potential future borrowing opportunity . . . ought [not] to be considered as a presently disabling factor in [S's] retention."

The Debtor's Bank Accounts with S

The court further rejected the UST's argument that S "might be required to give advice as to whether the Debtor's bank deposits should be moved," creating possible conflicts.

According to the court, this "contention . . . just reflects a misunderstanding of the services that investment banks provide," which have "nothing to do

with . . . where funds are deposited." It was hardly "a basis on which to refuse" S's retention." When the UST argued that "the sheer number of [S's] prior connections" created possible future risks, the court stressed the requirement of "specific issues" for disqualification, not "speculation" about "some unknown issue [that] might arise."

S's Purported Creditor Status

Code Section 101(14) excludes a "creditor" from "disinterested" status. Because S had been paid for its pre-bankruptcy services, the UST initially claimed S was a creditor but only dropped this line of attack during a court hearing because it had no "facts" showing that pre-bankruptcy payments "were improper in any way., or [were recoverable] as preferences."

Similarly, the debtors' pre-bankruptcy payments made to an S affiliate for credit card services were not preferential and did not make S a creditor.

Finally, as to S's guarantees of certain debtor obligations, S "waived any and all prepetition claims it has or may have for indemnification, reimbursement, or other similar amounts with respect to the guarantees," thereby eliminating the "creditor" issue.

COMMENTS

The UST's broad attack on the debtors' proposed retention of an investment bank shows how the UST has been scrutinizing financial advisor retentions in the past few years. Some of the scrutiny is valid, but why the issues raised here had not been resolved prior to judicial intervention is puzzling. S apparently had not been represented by counsel. Counsel for the debtors and the creditors' committee could not represent S, but the debtors' counsel effectively showed why the debtors properly wanted to retain S.

The court here also showed its understanding of investment banker services. That has not always been true. A little more than thirty years ago, however, a New York bankruptcy judge unfairly described the work of investment bankers in an reorganization cases as follows:

> Whenever we have dealt with investment bankers and financial advisors we have been left with the strong impression that for them the debtor is the cash cow to be milked, Chapter 11 the milking parlor and the Judge the milking stool. . . . It is clear the investment bankers want to sip the cream and leave the skimmed milk for others.[7]

[7] *In re Drexel Burnham Lambert Grp., Inc.*, 133 B.R. 13, 26 (Bankr. S.D.N.Y. 1991). *See also*

The *SAS* opinion now shows how investment bankers can and do add value in reorganization cases.

In re Hillsborough Holdings Corp., 125 B.R. 837 (Bankr. M.D. Fla. 1991) (questioning value of investment bankers' services).