

PENNSYLVANIA BAR INSTITUTE



THE SEVENTH ANNUAL BANKRUPTCY INSTITUTE

Conflicts of Interest Issues

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Michael A. Bloom, Morgan, Lewis & Bockius

Professor Karen Gross, New York Law School

The Honorable Stephen Raslavich, United States Bankruptcy Court Judge

Hypothetical No. 1



For the last decade, your law firm has represented OneWay Airlines, a domestic carrier with hub airports in Philadelphia and Miami. OneWay is a publicly traded corporation. Following deregulation of the airline industry, and faced with the loss of customers following the events of September 11, 2001 and increased competition and operating costs, OneWay's financial situation has deteriorated to the point where it now must consider filing for relief under Chapter 11.

As of August 1, OneWay owed your firm \$650,000, much of which was over 30 days outstanding. None of the receivables relate to bankruptcy planning issues. OneWay now asks you to advise it about a possible Chapter 11 filing.

Hypothetical No. 1 (cont'd.)



Prior to proceeding with the representation, what issues should you consider?

Issues:

1. Is your law firm “disinterested?”
2. Could your law firm require payment in full (or in substantial part) of its outstanding receivable prior to providing any bankruptcy-related advices to One Way? What problems, if any, would demanding and receiving such a payment create?

Hypothetical No. 1 (cont'd.)



3. Does it make a difference if the payment is made solely on account of future bankruptcy services?
4. Does not your law firm have a duty of loyalty to OneWay not to aggravate OneWay's existing financial condition and cash flow problems by demanding such a large payment at this time?
5. Does your law firm create further problems for itself by accepting such a payment within 90 days of the anticipated petition date?
6. Suppose the largest shareholder of OneWay offers to guarantee payment of the Firm's fees? Suppose, further, that the shareholder also is a Firm client?

Hypothetical No. 1A



In the course of your ongoing representation of OneWay, for several years the Firm has been defending both OneWay and its Board of Directors in a derivative shareholder class action filed by David Greenmail, Esquire.

Does this representation create any additional problems for the Firm in agreeing to become Debtor's counsel? What additional facts would you like to know?

Hypothetical No. 1B



Assume further that 18 months prior to OneWay's request for bankruptcy assistance, the Firm represented OneWay in a leveraged buyout in which the 13 principal shareholders of OneWay sold their controlling interests in OneWay to a consortium of investors who provided capital to OneWay principally by adding debt to its balance sheet and making a relatively small equity investment.


Can you represent OneWay and continue to simultaneously represent the original OneWay shareholders who also all are current clients of the Firm?

Hypothetical No. 1B (cont'd.)



Even if you conclude not to continue representing the shareholders and OneWay files for bankruptcy, would your Firm be permitted to represent OneWay as either its bankruptcy counsel or as special litigation counsel?

Hypothetical No. 2



At the direction of OneWay's Board of Directors, you file a petition under Chapter 11. After a thorough internal review of potential conflicts of interest, as of the petition date, your law firm represents the following entities in unrelated matters:

1. First National Bank ("FNB"). Does it make a difference whether:
 - FNB is the Agent Bank under OneWay's current Credit Agreement;
 - FNB is a participant lender in OneWay's current Credit Agreement;

Hypothetical No. 2 (cont'd.)



- FNB is OneWay's former principal lender whose loan was satisfied as part of the leveraged buyout 18 months before;
- FNB is a mortgage lender on a non-essential parcel of the Debtor's which may be sold during the Chapter 11 proceeding;
- FNB is a lender which may seek to provide the Debtor with debtor-in-possession financing?

Hypothetical No. 2 (cont'd.)



2. Suppose that you have represented FNB as a D-I-P lender in other Chapter 11 cases, but you do not believe that FNB would be interested in providing similar D-I-P financing to One Way?
- * For purposes of Questions 1 and 2 above, assume that fees received by your law firm from FNB during the Firm's last fiscal year amounted to .05% or 2% or 5% or 10% of the Firm's gross income.

Hypothetical No. 2 (cont'd.)



3. Highvalue & Sons, investment bankers. Highvalue & Sons served as the investment banker to OneWay in the leveraged buyout transaction.
4. Countem Again LLP, the former accountants to the Debtor at the time of the leveraged buyout transaction.
5. Seven unrelated owners of commercial real estate each of whom are lessors of a variety of leased office space, including the lessor of the Debtor's headquarters and executive offices.

Hypothetical No. 3



For the last 15 years, you have represented John and Mary Gilchrist who are the co-owners and sole shareholders of A-1 Cleaners, Inc., a Pennsylvania corporation which operates 5 local dry cleaning establishments. You have represented the Gilchrists in all of their legal business and personal matters over the years. As their lawyer, you incorporated A-1 Cleaners and have served from its inception as the third and only other Director.

Hypothetical No. 3 (cont'd.)



In the face of increased competition, A-1's business has suffered. The Gilchrists now seek your advice concerning possible options. You conclude that a Chapter 11 filing is desirable, but now must address the following issues:

1. John and Mary "borrowed" \$200,000 from A-1 Cleaners for their personal use. There is no formal documentation evidencing this loan arrangement between the Gilchrists and A-1.

Hypothetical No. 3 (cont'd.)



2. You have learned that the Gilchrists have been taking money “under the table” from A-1. Specifically, for the past three years, the Gilchrists routinely have drawn from A-1 approximately \$5,000 - \$10,000 in cash on a monthly basis with no record of such transfers on A-1’s books. You suspect, but you do not know for certain, that they have not reported these amounts as income on their personal income tax returns.

3. Additionally, you learn that they have used A-1’s revenues to pay for many of their personal expenses, including a recent addition to their home for their daughter who has returned to live with her newborn daughter.

Hypothetical No. 3 (cont'd.)



4. The Gilchrists have guaranteed A-1's loan from Friendly Neighborhood Bank. FNB holds a perfected security interest in all of the assets of the business and a second mortgage on the Gilchrist's home.
5. The Gilchrists ask you how they can protect their assets from A-1's creditors.

Hypothetical No. 3 (cont'd.)



- What conflicts, if any, do these commonly confronted issues present?
- Who is your client -- A-1 or the Gilchrists? Are the interests of these two parties adverse?
- If you decide that filing Chapter 11 bankruptcy is the best option for A-1, can you represent A-1 as debtor's counsel?

Hypothetical No. 3 (cont'd.)



- How, if at all, would your conclusions change if:
 - (1) you are owed fees by A-1 for legal services you previously had provided;
 - (2) you are owed fees by the Gilchrists for personal legal services you previously had provided;
 - (3) you had resigned as director 3 years ago; or
 - (4) you represent FNB in unrelated matters.

Hypothetical No. 3 (cont'd.)



- What is your professional responsibility with respect to the Gilchrists' questionable business practices and probable failure to have disclosed income on their personal income tax returns?