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Straight & Narrow

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A Review of Potential Conflicts in Private-Equity Representation

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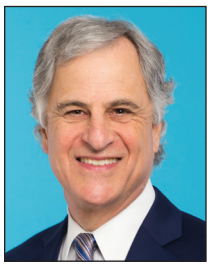

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Looking at the exhibit, suppose Law Firm has a long-standing private-equity client (Sponsor), which owns several portfolio companies. Law Firm has long represented Sponsor, including in acquiring companies. Law Firm also represents Sponsor's portfolio companies directly.

Suppose one of Sponsor's portfolio companies is financially distressed. Suppose the level of distress progresses from a need for covenant amendments in debt documents, to a need for equity infusion to support operations, to a valuation in which the equity is clearly out of money. Suppose Sponsor is willing to provide an equity infusion at one stage, but later determines that value is too impaired and simply wishes to exit the investment.

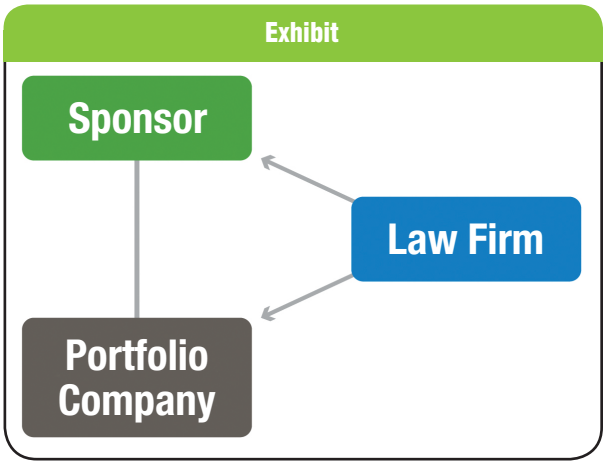
Is there a conflict? If so, when does it arise? May Law Firm represent both Sponsor and Portfolio Company as Portfolio Company navigates its financial distress? Does it matter whether Portfolio Company needs to restructure, might ultimately end up in bankruptcy, or might have claims against Sponsor? If there is a conflict or a potential conflict, may Sponsor and Portfolio Company waive the conflict? If not, may it represent one? Which one? May it continue to represent Sponsor on unrelated matters?

In New York, the applicable rule is New York Rules of Professional Conduct Rule 1.7, Conflict of Interest: Current Clients, which provides as follows:

> (a) Except as provided in paragraph (b), a lawyer shall not represent a client if a reasonable lawyer would conclude that either:
>
> (1) the representation will involve the lawyer in representing differing interests; or
>
> (2) there is a significant risk that the lawyer's professional judgment on behalf of a client will be adversely affected by the lawyer's own financial, business, property or other personal 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.[1]

In addition, because sponsor and portfolio representations often occur in a transactional set-

1 N.Y. Rules r. 1.7.



ting, guidance might come from the Professional Ethics Committee of the New York City Bar Formal Opinion 2001-2, which applies factors including how adversarial the relationship is between the lawyer's clients and whether the lawyer has a disproportionately important relationship with one client compared to the other such that the lawyer truly can provide undivided loyalty to both clients.[2]

Additional rules apply in bankruptcy. Section 327(a) of the Bankruptcy Code mandates that bankruptcy professionals "not hold or represent an interest adverse to the estate" and be "disinterested persons."[3] Under § 101(14) of the Code, a disinterested person "does not have an interest adverse to the interest of the estate or of any class of creditors or equity securityholders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason."[4] Bankruptcy Rule 2014 requires that any professional retained in the bankruptcy case disclose "to the best of the applicant's knowledge, all of the person's connections with the debtors, creditors, any other party-in-interest, their respective attorneys and accounts, the [U.S. Trustee], or any person employed in the office of the [U.S. Trustee]."[5]

If the restructuring involves only covenant amendments or even only an additional sponsor equity infusion, an actual conflict is unlikely, and the law firm could continue to represent both clients. However, conflicts might arise if the restructuring requires debt-reduction, conversion of debt to equity, or the sponsor's attempt to stay invested, even if there is no equity value. If so, the law firm might not represent both, especially if the portfolio company needs a chapter 11 case to affect the restructuring. Either the sponsor or portfolio company should retain independent counsel before an actual conflict arises. But neither the firm nor its clients can know at the outset whether or when the two entities might become adverse and create a conflict requiring separate counsel.

Once that occurs, with appropriate client consent, the law firm could retain the representation of the sponsor, and it will not need to negotiate against a valuable firm client. Or it might choose the portfolio company. This might be a more robust but more limited-duration engagement, since the portfolio company might end up with different ownership after the restructuring. For an insolvent portfolio company, retaining and educating new counsel is costly and onerous, especially if the firm handled the portfolio company's financing transactions that are later subject to renegotiation in a workout. If the company ends up in bankruptcy, navigating chapter 11 with unacquainted counsel is even more daunting. However, the firm might then have to investigate, negotiate against or even sue its sponsor client during a contentious restructuring effort.

Lawyers should think ahead early in a workout and consider the likelihood of potential intercompany claims before the portfolio company becomes insolvent and well before it needs to file a chapter 11 case. Without planning for the potential conflicts, the law firm's engagement in the chapter 11 case might be subject to challenge, resulting in additional, uncompensable fees, distraction from the case and possible disqualification.

> **A law firm that wishes to represent the portfolio company in its restructuring ... but also continue to represent the sponsor on "unrelated matters," must conclude that it can provide truly undivided loyalty to both clients....**

Law Firm Investment Committees

Adding another layer of potential conflicts, some law firms (through investment committees) arrange for partners to invest personal funds into a pool, which invests in firm clients, including sponsor clients, who then invest those funds in their portfolio companies. While the types of investment arrangements vary in the degree of partner control and knowledge over the particular investments, the lawyer representing the sponsor and portfolio company might have a personal financial interest in the outcome of the representation. This is a largely untested area of law that adds an additional risk for potential conflicts and disinterestedness in sponsor and portfolio company representations.

The *Indalex* bankruptcy case raised this issue.[6] There, a group of law firm partners created an investment pool to make investments alongside the law firm's private-equity sponsor clients. Each partner determined whether and in what amount to invest in a pool; however, the firm itself never invested in these pools. A partners' management committee managed the pools and determined how to invest committed capital.

Once the capital is committed to a client-managed private-equity fund, the management committee and the individual partners do not direct the sponsor client or know what portfolio company its sponsor will acquire, although they typically learn afterward. Here, the law firm represented the sponsor in its acquisition of the debtor and disclosed in the sponsor's offering memorandum that "[s]ome of the partners of [the law firm] are partners in a partnership that is an investor in one or more of the investment funds affiliated with [the sponsor] that may purchase common stock of Indalex parent in connection with the Acquisition."[7]

When the client sponsor acquired the debtor, the debtor also retained the law firm. The firm's engagement letter "specifically informed" the debtor of its dual representation, and "sought and obtained a purported waiver from Indalex of past, present, and future conflicts arising from [the law firm's] representation of [the sponsor]."[8] However, the engagement letter did not disclose the partners' indirect investments in the sponsor's fund or the sponsor's use of such funds to invest in the debtor.[9] Fifteen months after the sponsor's acquisition of the debtor, the debtor "issued an

2 NYCB Opinion 2001-2, *available at* nycbar.org/member-and-career-services/committees/reports-listing/reports/detail/formal-opinion-2001-2-conflicts-in-corporate-and-transactional-matters (last visited Dec. 3, 2018).
3 11 U.S.C. § 327(a).
4 11 U.S.C. § 101(14).
5 Fed. R. Bankr. P. 2014(a).
6 *Miller v. Kirkland & Ellis LLP (In re 1H 1 Inc.)*, Case No. 09-10982, Adv. Proc. No. 12-50713, 2016 WL 6394296 (D. Del. Sept. 28, 2016).
7 *Id.* at *3.
8 *Id.*
9 *Id.*

approximate $76.6 million dividend ... to its ultimate stockholders, the largest of which was [the sponsor]. Numerous [law firm] partners also received a distribution through their indirect investments."[10] The law firm had represented both the sponsor and portfolio company with respect to the payment of the dividend. The chapter 7 trustee sued the firm, alleging that it was negligent in the advice it provided to the debtor, and sought judgment for aiding and abetting breach of fiduciary duty and for legal malpractice. The court ultimately dismissed the case on statute-of-limitations grounds and the trustee's failure to submit appropriate expert testimony.[11]

The potential risk inherent in these investment pools is that a lawyer might represent potentially conflicting interests of sponsor and portfolio company while having a personal financial stake in the outcome. Pursuant to New York Rules of Professional Conduct Rule 1.8, "Current Clients: Specific Conflicts of Interest Rules," a lawyer shall not enter into a business transaction with a client if they have differing interests and if the client expects the lawyer to exercise professional judgment for the protection of the client unless (1) the transaction is fair and reasonable to the client, (2) the client is advised in writing of the desirability of seeking the advice of independent legal counsel on the transaction, and (3) the client gives informed written consent.[12] May the lawyer truly provide undivided loyalty to both clients in these circumstances? If the portfolio company fails, is the lawyer "disinterested" under the Bankruptcy Code — *i.e.*, is the lawyer one who does not have "an interest 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, connection with, or interest in, the debtor, or for any other reason"?[13]

While not a case involving dual representation of sponsor and portfolio companies, the pending litigation between Jay Alix and McKinsey & Co. has highlighted the issue of such firm investments.[14] Like law firms, financial advisors are also subject to the disinterestedness and disclosure requirements.

While it is not a case involving law firm conflicts, this ongoing litigation shows that disclosure of any and all investments in the debtor, creditors or parties-in-interest (regardless of whether the investments are made through a subsidiary, affiliate or a "committee" of firm members, as in the *Indalex* case) as a "connection" under Bankruptcy Rule 2014 can prevent future questions and is therefore a better practice. A direct line from the professional to the party-in-interest through such investments might in fact impact the disinterestedness analysis under § 327 of the Bankruptcy Code, depending on the professional's knowledge of and control over the investments.

Conclusion

A potential for conflict in representing both a sponsor and its distressed portfolio company arises when the portfolio company needs to take action against the sponsor's financial interest or to assess claims against its sponsor. A law firm that wishes to represent the portfolio company in its restructuring (many do, since debtor representation is more challenging and lucrative), but also continue to represent the sponsor on "unrelated matters," must conclude that it can provide truly undivided loyalty to both clients, including on matters potentially adverse to the sponsor, and that its judgment will not be compromised if it must bite the hand that feeds it (*i.e.*, the sponsor).[15]

Although the effect of a professional's personal investments in its sponsor clients (and ultimately the portfolio companies they own and control) is not yet decided in the Alix litigation, the U.S. Trustee and bankruptcy courts will likely look more closely at potential conflicts, disinterestedness and disclosures by professionals in these contexts. Professionals are well advised to (1) make robust disclosures to both sponsors and portfolio companies, including regarding any dual representations and personal investments; (2) obtain clear, specific waivers for potential conflicts arising out of such representations or investments; (3) reevaluate their engagements at the onset of any financial distress; (4) consider whether new counsel should be retained and for which client(s); and (5) double-check conflicts and bankruptcy disclosures to ensure full and complete disclosure of all connections. As the U.S. Trustee explained in *Alpha Resources*, "Full and complete disclosures ensure that bankruptcy professionals render undivided loyalty and untainted advice to their clients and enhance creditor and public confidence in the fairness of the bankruptcy proceedings. Rule 2014 is a rigorous standard requiring full disclosure of all connections so that parties and the Court can thoughtfully reach such conclusions."[16] abi

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10 *Id.* at *4.
11 *Id.* at *10-29.
12 N.Y. Rules r. 1.8(a).
13 11 U.S.C. § 101(14).
14 *Jay Alix v. McKinsey & Co.*, Case No. 18-cv-04141 (S.D.N.Y.), Complaint at Dkt. 1, ¶¶ 63; 105-110; *In re Alpha Natural Res. Inc.*, Case No. 15-33896 (Bankr. E.D. Va.), Dkt. 4124.
15 NYCB Opinion 2001-2, *supra* n.2.
16 *In re Alpha Natural Res. Inc.*, Case No. 15-33896 (Bankr. E.D. Va.), Dkt. 4126 at ¶ 9.