

The 1 Percent Rule Needs Fixing¹

Written by:

Kenneth A. Rosen

Lowenstein Sandler LLP; Roseland, N.J.

www.lowenstein.com

Conflicts inevitably arise within law firms. Those familiar with chapter 11 likely know about the “1 percent rule,” which requires law firms to disclose if a secured creditor accounts for more than 1 percent of its annual revenues. Less than 1 percent is deemed “de minimus,” or inconsequential, in that representing the creditor is considered either conflict-free or, more likely, an acceptable level of conflict.

For law firms with revenues in the nine or 10 figures, 1 percent of annual revenues can be serious money. We all dread the call from the fellow partner who says, “I received a call from my client, who is very unhappy about what you are doing in his chapter 11 case. This client is important to the firm and to me.” What happens now? Hopefully, the partner on the other end of the phone is not a member of your compensation committee.

Is the fact that the complaining (or potentially complaining) client represents less than 1 percent of the firm’s revenues meaningful? Without context, it is really just a number in a vacuum. It provides no real insight into whether the legal team working on the debtor’s or committee’s case would likely be influenced, nor does it provide insight into whether the team working on the chapter 11 case is likely to be influenced, even without an angry telephone call from the client or its attorney.

Assume that the attorney signing a retention application has actual knowledge of the revenues of the potential complainant. Also assume that the law firm’s revenues are \$501 million, of which \$5 million would be less than 1 percent. Can it honestly be said that a \$5 million client is one that an attorney is willing to alienate? An attorney might say, “It’s my partner’s client, not mine,” but that is hardly a proper response.

The actual amount of revenue from the party with the possible conflict should be disclosed in retention papers, as should the names of the partners who work for that client. It makes a big difference if the partner signing the retention application is one of the firm’s partners who frequently represents the (potentially) complaining client.

Debtors are often well served when hiring larger firms, simply for the sake of efficiency and the wider breadth of services offered. But the larger a firm’s portfolio of clients, the more likely that conflicts of interest can arise.

I oppose blanket prohibitions that deem firms to have disabling conflicts if they do substantial work for another client with a potentially conflicting interest. The additional facts should of

¹ The views expressed herein are those of the author individually and are not necessarily those of Lowenstein Sandler LLP or any other person.

course be disclosed, and then all parties can better evaluate whether any precautionary measures (or no measures) are necessary.

Usually, there is a secured lender, which often has a “blanket” security interest, but in larger cases, the secured loan may have several participating lenders, which means more opportunity for conflicts. Tension between secured lenders and the debtor, as well as between secured lenders and a creditors’ committee, is common in chapter 11 cases.

There will be times when a large law firm must step aside on a particular matter within a case because of conflicts — especially when it comes to negotiating a “DIP” financing order or a cash collateral order. Bankruptcy courts should therefore be liberal in permitting a debtor or creditors’ committee to retain special counsel to avoid conflict. However, courts should also recognize that these types of issues are likely to arise with *any* large law firm — and that large chapter 11 cases need large law firms.

In a well-run chapter 11 case, the bankruptcy court may have the benefit of receiving input from several sophisticated parties (*e.g.*, creditors’ committee, U.S. Trustee, indenture trustee, union, PBGC, bondholders, lessors, etc.) — all of whom have an opportunity to be heard by the court, which can help vet issues in a thorough way. That might make potential and actual conflicts acceptable under the circumstances, but it does not excuse a lack of full disclosure.

The question is how to reasonably deal with conflicts under these types of circumstances. More information should be disclosed in retention papers so that it can be weighed, including: (1) the size of the case; (2) the number of active parties involved; (3) the amount of the secured creditor’s claim; (4) when the secured loan was made; (5) what law firm documented the loan; (6) what issues are likely to arise regarding the secured creditors’ claim; (7) the actual revenues that the secured lender represents to the firm; (8) the size of the firm; and (9) who at the firm works on behalf of the secured creditor.

Some level of conflict is inevitable in a chapter 11 case, however, so an attorney might hesitate to put his or her name on a complaint to recover preferences from unsecured creditors whose votes the attorney might need in a future bankruptcy case in which the attorney seeks to become committee counsel. An attorney with a diverse practice (one that represents debtors, committees and lenders) could pause when determining whether to go to battle with a lender that the attorney hopes will become a client in a future case. An attorney could also find him/herself representing an ad hoc committee of secured bondholders in a battle with unsecured bondholders that he or she also represents in other cases.

I believe that the bankruptcy system already deals adequately with these issues with its inherent combination of checks and balances. Many parties are entitled to notice and an opportunity to be heard, which ensures that issues are adequately vetted and that the court is fully informed. Therefore, while courts should recognize the inevitability of some conflicts and should apply the 1 percent rule *generally*, the rule should require greater disclosure and should be subject to a more thorough analysis of conflict under the specific facts of the case.

Editor’s Note: *ABI welcomes other views on this subject.*