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THE AMERICAN BANKRUPTCY INSTITUTE

Final Report of the American Bankruptcy Institute National Ethics Task Force

April 21, 2013

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Introduction

In 2011, then-American Bankruptcy Institute President Geoffrey L. Berman established the ABI's National Ethics Task Force¹ to address a problem familiar to all bankruptcy professionals and judges: state ethics rules do not always “fit” with the realities of bankruptcy practice. State ethics rules may also not be a perfect fit in the context of other types of practice, either—for example, states may not yet know how best to handle the increasingly interconnected digital and virtual world—but it is clear that the Model Rules do not fit neatly with the realities of a bankruptcy practice that involves numerous parties with changing allegiances, often departing from the classic two-party adversarial proceeding.²

Shortly after President Berman appointed the Task Force's members, the Task Force met to discuss the best way to approach its assignment. At its first meeting, the Task Force promulgated its mission statement:

The ABI National Ethics Task Force will consider ethics issues in bankruptcy practice and will make recommendations for uniform standards, where appropriate.

In essence, the Task Force was charged with answering the question of whether there is a need for national ethics rules, standards, and general practice guidance in the bankruptcy context.³

As the Task Force considered the various topics and issues that could potentially be addressed, a few “jumped out.”⁴ These included the conflicts-related issues that result from the shifting allegiances that can arise during the life of a bankruptcy case, the complexity of disclosure of “connections” when seeking approval of employment, the fleshing out of the duties of counsel for a debtor in possession, and the role of conflicts counsel in business reorganization cases. Other issues implicated in the context of bankruptcy practice, while not specifically at odds with state ethics rules—for example, the concept of attorney competency and the pressing question of how to balance the need for a capable and skilled bar with the need to provide consumers in financial distress access to the bankruptcy system—were addressed in order to provide needed guidance to bankruptcy attorneys.

¹ Past-President Berman and current President James Markus—with the help of the ABI's Anthony H. N. Schnelling Endowment Fund—have provided significant support for the Task Force's work.

² *Cf. In re* Nguyen, 447 B.R. 268, 277 (9th Cir. Bankr. 2011) (“[T]he ABA Standards, which were developed primarily for nonfederal, nonbankruptcy courts by unelected and nonjudicial parties, are ill-adapted to federal bankruptcy proceedings. The ABA Standards were not drafted to address the distinctive context of bankruptcy where, as here, administrative matters rather than litigation may be the focus of an attorney's work.”) (referring to the American Bar Association Standards for Imposing Lawyer Sanctions and citing *In re* Brooks-Hamilton, 400 B.R. 238 (9th Cir. Bankr. 2009) (citation omitted)).

³ The ABI has established a separate Civility Task Force, chaired by James Patrick Shea of Shea & Carlyon.

⁴ The Task Force also adopted a set of bylaws.

The Task Force began its work by forming several committees, each focused by topic. Each committee developed initial memoranda on issues that fell within the purview of its subject area. The committees' topics included (1) conflicts of interest, (2) disclosure, retention, and fee issues, (3) consumer issues, (4) committee solicitation issues, and (5) discipline, sanctions, competence, and multi-jurisdictional practice issues. Each committee member attended regular committee meetings, in addition to teleconferences and quarterly meetings of the entire Task Force. The Reporters also held quarterly retreats at which the Reports were researched and drafted.⁵ Each Task Force member had the opportunity to comment on the Reporters' draft Reports, and each draft Report was ultimately voted on and approved by the entire Task Force. Although, in its work, the Task Force reviewed several 50-state surveys of particular state ethics rules,⁶ it used the American Bar Association's MODEL RULES OF PROFESSIONAL CONDUCT in addressing the issues discussed in this Final Report.⁷

The Task Force also found several worthy topics—including the issue of retainers and employment, standards for practice competency for creditors' counsel, and the issue of ghostwriting a debtor's petition and schedules as a way of addressing bankruptcy access—that the constraints of this Task Force prevented it from fully developing. It is our expectation that these important issues will be taken up in the near future by another ABI working group or committee.

All of the Reporters' White Papers and Proposals are compiled within this Final Report. They are as follows:

1. Proposed Amendments to Rule 2014.⁸
2. Duties of Counsel for a DIP as Fiduciary and Responsibilities to the Estate.
3. A Framework for Pre-Approval of Terms for Retention and Compensation Under 11 U.S.C. § 328.
4. The Use of Conflicts Counsel in Business Reorganization Cases.
5. Best Practices for Limited Services Representation in Consumer Bankruptcy Cases.
6. Competency for Debtors' Counsel in Business and Consumer Cases.
7. Report on Best Practices on Creditors' Committee Solicitation.

⁵ The Reporters were ably assisted by Research Assistants Bridget McMahon, University of Maine School of Law, Class of 2014, and by David Rothenberg and Nicole Scott, William S. Boyd School of Law, UNLV, Class of 2014. The Reporters would also like to thank Heidi Gage for her excellent research and administrative assistance.

⁶ The Task Force gratefully acknowledges the research support provided by the reference librarians of the Wiener-Rogers Law Library at the William S. Boyd School of Law.

⁷ The Task Force recognizes that the Model Rules do not have the force of law; however, so many states have adopted the Model Rules in part or in whole that the Task Force determined that the discussion of the Model Rules, rather than state ethics rules, would be more useful to most ABI members.

⁸ One of the Task Force's Reports—the Report on Proposed Amendments to Rule 2014—has been transmitted to the Advisory Committee on Bankruptcy Rules, which will be reviewing the Report before its Fall meeting.

The Task Force recognizes that much more needs to be done in terms of ethics issues facing the bankruptcy bar and bankruptcy bench—and discussions have already begun with ABI’s leadership as to how best to proceed with further review and discussion of ethics issues—but it is pleased to present to you this Final Report and it looks forward to the discussion that will follow.

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Proposed Amendments to Rule 2014

Introduction¹

Sections 327² and 1103³ of the Bankruptcy Code set forth specific standards that proposed professionals must meet in order to be retained as an estate or committee professional.⁴ Each of these provisions requires the professional in question to meet certain standards relating to their independence from parties other than their client in a case.⁵ As noted by several courts, “[t]he purpose of Rule 2014(a) is to provide the court and the United States trustee with information to determine whether the professional's employment is in the best interest of the estate. . . . Rule 2014 disclosures are to be strictly construed and failure to disclose relevant connections is an independent basis for the bankruptcy court to disallow fees or to disqualify the professional from the case.”⁶

In order for courts, the Office of the U.S. Trustee and other parties in interest to evaluate employment applications, Federal Rule of Bankruptcy Procedure 2014 requires professionals to disclose to the court those facts related to actual or potential conflicts of interests they may have.⁷ FRBP 2014 currently provides:

(a) Application for an order of employment. An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to § 327, § 1103, or § 1114 of the Code shall be made only on application of the trustee or committee. The application shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States trustee. The application shall state the specific facts showing

¹ The Reporters are grateful to Chip Bowles for all of his hard work on this project.

² 11 U.S.C. § 327 (2013).

³ 11 U.S.C. § 1103 (2013).

⁴ See, e.g., *In re Crivello*, 134 F.3d 831, 836 (7th Cir. 1998).

⁵ See 11 U.S.C. § 101(14) (2013) (definition of disinterested person); *In re Marvel Entertainment Corp.*, 140 F.3d 463, 476 (3rd Cir. 1998) (discussing adverse interests and actual vs. potential conflicts of interest).

⁶ See, e.g., *Exco Res. v. Milbank (In re Enron Corp.)*, No. 02 Civ. 5638 (BSJ), 2003 U.S. Dist. WL 223455, at *4 (S.D.N.Y. Jan. 28, 2003); *Banner v. Cohen, Estis & Assocs., LLP. (In re Balco Equities Ltd.)*, 345 B.R. 87, 111 (Bankr. S.D.N.Y. 2006).

⁷ Of course, there are state ethics rules that are implicated as well, including issues related to conflicts of interest and candor to the tribunal. We are focusing here on the bankruptcy issues. For a discussion of the application of Rule 2014, see generally, *U.S. v. Gellene*, 182 F.3d 578, 582 (7th Cir. 1999); *Halbert v. Yousif*, 225 B.R. 336, 346 (E.D. Mich. 1998). See also *In re Plaza Hotel Corp.*, 111 B.R. 882, 883 (Bankr. E.D. Cal. 1990), *aff'd* without op., 123 B.R. 466 (9th Cir. BAP 1990); *In re Gluth Bros. Constr.*, 459 B.R. 351, 364 (Bankr. N.D. Ill. 2011); *In re Bellevue Place Assocs.*, 171 B.R. 615, 626 (Bankr. N.D. Ill. 1994) (holding that purpose of 2014 “is to avoid even appearance of a conflict regardless of the integrity of the professional seeking to be employed”).

the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, all of 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. The application shall be accompanied by a verified statement of the person to be employed 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.

(b) Services rendered by member or associate of firm of attorneys or accountants. If, under the Code and this rule, a law partnership or corporation is employed as an attorney, or an accounting partnership or corporation is employed as an accountant, or if a named attorney or accountant is employed, any partner, member, or regular associate of the partnership, corporation or individual may act as attorney or accountant so employed, without further order of the court.

Currently, FRBP 2014 does not limit the extent of disclosure of a professional's connections⁸ with: (i) the debtor; (ii) any creditors of the debtor; (iii) other parties in interest; (iv) attorneys of the debtor, creditors, and parties in interest; (v) accountants for the debtor, creditors, and parties in interest; and (vi) the United States Trustee and persons employed by the U.S. Trustee's office (collectively, "2014 Parties"). Indeed, most courts that have addressed this issue have held that professionals have little, if any, discretion in determining whether a connection is "relevant" to their employment application.⁹

⁸ See *In re Gluth Bros. Constr.*, 459 B.R. 351, 364 (Bankr. N.D. Ill. 2011), where the court stated:

The term "connections" used in Rule 2014(a) is considerably broader than the terms "disinterested" and "interest adverse to the estate" used in Section 327(a). Thus an attorney must disclose a connection even if he does not believe it would disqualify him under Section 327(a). As the Seventh Circuit Court of Appeals has stated, professionals "cannot pick and choose which connections are irrelevant or trivial." *U.S. v. Gellene*, 182 F.3d 578, 588 (7th Cir. 1999) (internal citation omitted). Instead, no "matter how trivial a connection appears to the professional seeking employment, it must be disclosed." *In re Envirodyne Indus.*, 150 B.R. 1008, 1021 (Bankr. N.D. Ill. 1993) (Schwartz, J.). Counsel who "fail to disclose timely and completely their connections proceed at their own risk because failure to disclose is sufficient grounds to revoke an employment order and deny compensation." *Gellene*, 182 F. 3d at 588 (quoting *In re Crivello*, 134 F.3d 831, 836 (7th Cir. 1998)). Thus "denial of fees or disqualification may be justified [33] even when the professional is in fact disinterested." *In re Raymond Professional Group, Inc.*, 421 B.R. 891, 906 (Bankr. N.D. Ill. 2009) (quoting *In re Midway Indus. Contractors*, 272 B.R. 651, 662 (Bankr. N.D. Ill. 2001)).

⁹ See generally *In re Crivello*, 134 F.3d 831 (7th Cir. 1998); *In re Park-Helena Corp.*, 63 F.3d 877 (9th Cir. 1995); *Rome v. Braunstein*, 19 F.3d 54 (1st Cir. 1994); see also *In re Rusty Jones, Inc.*, 134 B.R. 321, 346 (Bankr. D. Ill. 1991) (noting the fact the professional owned a hot dog stand over 20 years before the bankruptcy with an indirect owner of the debtor was a *de minimis* connection).

The broad but undefined term “connection” has led to confusion¹⁰ over the appropriate level of inclusiveness in disclosures.¹¹ The uncertainty surrounding the meaning of “connection” has also led to attempts by professionals to argue that some important “connections are immaterial.”¹² The following proposed new FRBP 2014 is an effort to provide clarity to professionals concerning what relevant connections must be disclosed, as well as to provide improved information for courts and other parties to use in determining a professional’s eligibility for employment.

Current Rule 2014

Current Rule 2014 reads as follows:

(a) Application for and Order of Employment. An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to §327, §1103, or §1114 of the Code shall be made only on application of the trustee or committee. The application shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States trustee. The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, all of 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. The application shall be accompanied by a verified statement of the person to be employed 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.

(b) Services Rendered by Member or Associate of Firm of Attorneys or Accountants. If, under the Code and this rule, a law partnership or corporation is employed as an attorney, or an

¹⁰ *In re Rusty Jones, Inc.*, at 346, 134 B.R. 321 (Bankr. D. Ill. 1991) (discussing whether ownership of a hot dog stand with a 2014 party 20 years before bankruptcy was filed was a connection required to be disclosed).

¹¹ *In re EWC*, 138 B.R. 276, 280 (Bankr. W.D. Okla. 1992) (“duty of professionals is to disclose all connections with the debtor, debtor in possession, insiders, creditors and parties in interest . . . they cannot pick and choose which connections are irrelevant or trivial . . . No matter how old the connection, no matter how trivial it appears, the professional seeking employment must disclose it.”).

¹² *See In re etoys Inc.*, 331 B.R. 176, 197 (Bankr. D. Del. 2005) (committee counsel, which was ultimately sanctioned \$750,000, argued failure to disclose business arrangement between committee counsel and the president of the debtor was not disqualifying as committee counsel was not required to be disinterested under 11 U.S.C. § 1103).

accounting partnership or corporation is employed as an accountant, or if a named attorney or accountant is employed, any partner, member, or regular associate of the partnership, corporation, or individual may act as attorney or accountant so employed, without further order of the court.

Proposed Amended Rule 2014

In comparison, the proposed amended Rule 2014 provides:

(a) APPLICATION FOR AND ORDER OF EMPLOYMENT. An application for an order approving the employment of a professional under § 327, § 1103, or § 1114 of the Code shall be made in writing and shall be made by the trustee, debtor in possession, or committee.¹³ The application shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States Trustee. The application shall contain:

- (1) specific facts demonstrating the necessity for the employment;
- (2) the identity of the professional to be employed, the reasons for the selection of the professional, and the list of the professional's employees, members, owners, and partners most likely to work on the matter;
- (3) a description of the professional services to be rendered;
- (4) a description of any proposed arrangement for compensation, including a statement of whether the professional is seeking approval of compensation standards under 11 U.S.C. § 328(a);
- (5) a statement that, to the best of the applicant's knowledge, the professional is eligible under the Code for employment for the purposes set forth in the application;
- (6) a description of the investigation undertaken and the procedures used by the applicant to determine that the professional is eligible for the proposed employment, including specifically the actions that the professional undertook to identify those connections that are material under the circumstances, including personal, business, and professional connections, that would be relevant to the court in determining whether the professional was free of any disqualifying current or potential bias;
- (7) if the professional is to be employed in multiple affiliated cases, a description of relevant inter-company relationships, including any potential conflicts among the affiliated debtors and any proposed allocation of compensation of the professional to be paid by each affiliate; and
- (8) for professionals seeking approval of employment by a committee,
 - (a) a statement of the process by which the professional sought employment by that committee, including interactions with other professionals; and

¹³ As for court-appointed experts, we expect that a court will set its own disclosure procedures for them.

- (b) a disclosure of any direct and indirect contacts and communications with a person eligible for the committee or who sought to be appointed to the committee.

(b) STATEMENT OF PROFESSIONAL. The application shall be accompanied by a verified statement by an authorized representative of the professional, made according to the best of that person's knowledge, information, and belief, and formed after an inquiry reasonable under the circumstances, that shall:

- (1) state that the professional is eligible under the Code for employment for the purposes set forth in the application;
- (2) describe the investigation undertaken and the procedures used by the professional in order to make its determination of eligibility for the employment set forth in the application;
- (3) describe any interest that the professional, or any employee, member, owner, or partner of the professional, holds or that the professional represents that is adverse to the estate;
- (4) describe any relationship that the professional, or any employee, member, owner, or partner of the professional, has that would implicate Federal Rule of Bankruptcy Procedure 5002 [Restrictions on Appointments];
- (5) state whether the professional, or any employee, member, owner, or partner of the professional, has shared or has agreed to share any compensation with any person, other than an employee, member, owner, or partner of the professional, and if so, describe the terms of any such arrangement;
- (6) disclose the source and describe the amount of any retainer to be paid, and if such retainer is to be paid from a creditor's collateral, whether such use is within the scope of authorized use of that collateral;
- (7) describe any guarantee of payment, enhancements of payment, or any collateral securing the payment of compensation and state the relationship of the guarantor with the debtor or committee and the professional;
- (8) disclose any payments for prepetition work received by the professional within 90 days of the petition's filing, and all facts that may be relevant to a preference analysis under 11 U.S.C. § 547;
- (9) disclose any conflicts waiver requested or obtained and the scope of that waiver, including any waiver limitations on actions the professional may or may not take during the case; and
- (10) describe the Relevant Connections, as defined in subsection (c) below, including any applicable materiality thresholds used, with the following persons, parties, or entities:
 - (A) the debtor;
 - (B) creditors of the estate;
 - (C) known or anticipated post-petition creditors of the estate;
 - (D) equity security holders of the debtor or of affiliates of the debtor;
 - (E) officers and directors of the debtor;
 - (F) parties that are insiders of the debtors or that were insiders of the debtor within 2 years before the date of the filing of the petition;
 - (G) any investment banker for any outstanding security of the debtor;
 - (H) the United States trustee;

- (I) customers of the debtor or vendors to the debtor whose transactions with the debtor as of the petition date constitute a material portion of the debtor's business;
- (J) parties to executory contracts and unexpired leases;
- (K) utility service providers;
- (L) governmental units and officials and employees thereof;
- (M) members of any committee appointed under 11 U.S.C. § 1102 or otherwise subject to disclosure under Rule 2019;
- (N) any identified potential asset purchasers; and
- (O) any professional employed by any of the above persons, parties or entities.

All disclosures made under this Rule shall be made in a format that describes the Relevant Connections in sufficient detail so the court and parties in interest may recognize potential biases and conflicts. For the Relevant Connections listed in subparagraph (b)(10), such disclosures should also be indicated in a grid substantially conforming to the New Proposed Official Form for Rule 2014 Disclosures, and that grid should cross-reference the relevant paragraphs in the narrative disclosure itself.

(c) RELEVANT CONNECTION. For purposes of this Rule, and unless otherwise defined by the court, "Relevant Connection" means,

- (1) any connection with a person or entity listed in subsection (b) that:
 - (A) on or within two years of the filing of the petition, generated a material amount of income and/or transfers;
 - (B) involved or was related to property of the estate with a material value;
 - (C) involved a material business venture with the person or entity; or
 - (D) involved working for the person or entity as a professional and generating a material amount of fees in the two years prior to the filing of the petition;
- (2) any connection with the court to which the employment application is being submitted;
- (3) any connection with the United States Trustee or any person employed in the office of the United States Trustee; or
- (4) any other connection constituting a personal, professional, or business relationship that could reasonably be determined to be significant in its evaluation of whether a professional is qualified to be employed.

With respect to each Relevant Connection, the applicant shall disclose personal and professional relationships and other connections relevant to determining the existence of bias or influence on professional judgment. Any materiality threshold used by the applicant for each Relevant Connection shall be set forth in the application. If the court directs use of a different threshold, the professional shall amend its disclosures to conform to such threshold. The list of Relevant Connections is intended to be comprehensive and encompass connections relevant to the court's consideration of the application. Any additional relevant connections necessary to prevent the application and the professional's verified statement from being materially misleading shall be included.

(d) SERVICE AND TRANSMITTAL OF APPLICATION. The applicant shall serve a copy of the application on:

- (A) the United States trustee;
- (B) the debtor and the debtor's attorney;
- (C) any committee elected under § 705 or appointed under § 1102, or, if the case is a chapter 9 case or a chapter 11 case and no committee of unsecured creditors has been appointed, on the creditors included on the list filed under Rule 1007(d); and
- (D) any other entity as the court may direct.

(e) SERVICES RENDERED BY MEMBER OR ASSOCIATE OF FIRM OF EMPLOYED PROFESSIONAL. If the court approves the employment of an individual, partnership, corporation, or other business entity, then any employee, member, owner, or partner of the professional working with the professional so employed may act as a professional so employed, without further order of the court, provided that the employee, member, owner, or partner of the professional has not been screened off from the employment due to a conflict of interest. If a partnership is employed, a further order approving employment is not required if the partnership agreement has been amended solely because of the addition or withdrawal of a partner.

(f) SUPPLEMENTAL STATEMENT OF PROFESSIONAL.

- (1) The professional has a continuing duty to file a supplemental statement regarding any new Relevant Connections for as long as the professional is employed.
 - (2) The professional shall regularly undertake a reasonable investigation to determine whether any additional Relevant Connections have developed and whether previously disclosed Relevant Connections should be updated, and in any event, shall undertake an investigation at the following times:
 - (A) before filing any adversary proceeding or before filing a response to any such adversary proceeding involving such professional;
 - (B) within 28 days after any amendment to bankruptcy schedules is filed;
 - (C) when a bidder for estate assets or purchase of estate assets outside the ordinary course of business is publicly identified; and
 - (D) before filing any interim or final fee application.
 - (3) Such supplemental statements shall be served on each entity listed in Rule 2014(c), and, unless the case is a chapter 9 case, on the United States Trustee.
- (g) The court may set a threshold for materiality of Relevant Connections.

Comment on Proposed Amended Rule 2014

The appropriate threshold will vary depending on the size and type of case, and the applicable Relevant Connection. For a strip mall “mom & pop” debtor, a minimum threshold on size of creditor claims used to determine which names to check for conflicts would likely not be appropriate. A *Delta Airlines* or *Enron* case, on the other hand, would likely warrant a considerably higher threshold. Likewise, all equity owners would need to be disclosed for a small debtor, but for a publicly-traded debtor, a securities law threshold for identified equity owners would be an appropriate threshold. There will be significant variance in threshold levels given the range of case sizes. It is likely that Delaware and New York City courts would allow higher thresholds that would be considered unacceptable in other jurisdictions. If the thresholds used are set forth—and parties in interest and the court have the opportunity to question them—at the beginning of the case, the Rule is flexible enough to be used across the board in all parts of the country.