BANKRUPTCY LAW ALERT
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Accountants Beware: Avoid Disclosure Violations in Bankruptcy Cases

Accounting firms (and professionals generally) should be mindful that the bankruptcy arena can be particularly unforgiving to those who are unfamiliar with the disclosure obligations imposed upon professionals retained by the debtor or the estate.

Consider the following scenario: Your accounting firm is retained in a chapter 11 bankruptcy case. On behalf of the firm, you sign a declaration drafted by the debtor's bankruptcy counsel and disclose the obvious connections between your firm and the debtor and/or its creditors. Your firm performs critical services for the debtor, including preparing monthly operating reports and tax filings as well as important accounting analyses, budgets, and projections. After months of providing these services, your firm accrues $50,000 in fees. Your firm applies to the bankruptcy court for entry of an order approving payment from the estate, and seemingly, out of nowhere, a creditor challenges your firm's compensation.

In its objection, the creditor argues that your firm failed to disclose a connection between your firm and the debtor's affiliate prior to the bankruptcy. The U.S. Trustee sees the creditor's objection and joins the bandwagon, pushing for the disqualification of your firm and denial of all fees. Although your firm argues that this connection does not constitute a conflict of interest because that affiliate is not a creditor in the bankruptcy case, the bankruptcy court denies your compensation because the connection was not disclosed at the time your firm was retained.

This hypothetical portrays a grim (but realistic) scenario that many accountants have actually experienced. Accountants that fail to satisfy their disclosure obligations risk the denial or disgorgement of their fees, despite their invaluable services and contributions to the estate. This alert offers practical guidance to help avoid that outcome.

The Law

Bankruptcy Rule 2014 requires professionals seeking employment under Section 327 of the Bankruptcy Code to disclose any "connections" that they may have 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." As used here, the term "connections" is expansive.

Connections can be financial, professional, or even personal. Further, such connections must be disclosed even if they do not pose a current conflict of interest. It is not up to the professional to decide what rises to the level of a "conflict of interest." Bankruptcy courts are clear that a professional who fails to disclose any connection, no matter how trivial, does so at his or her own risk. This is because it is the professional's absolute duty to disclose and the bankruptcy court's duty to determine whether a conflict ultimately exists based on those disclosures. The risk a professional takes by failing to disclose is amplified by the fact that the court reviews disclosure violations on a case-by-case basis, which necessarily introduces significant uncertainty into an already onerous situation.

But, bankruptcy courts generally agree that a professional's failure to disclose a connection is sufficient grounds for the professional's complete or partial denial of compensation, even if the services rendered were essential or critical to the administration of the bankruptcy estate. Retroactive disclosures do not always serve as a cure.

Safeguards to Consider Implementing

Practical safeguards are available to avoid disclosure violations.

Search Your Connections. Accountants anticipating employment by the estate in a bankruptcy case should consider preparing an internal list of relevant connections. Proper maintenance of this list throughout the case is important because your duty to disclose new connections to the court is ongoing.

Know Your Jurisdiction. It is also essential to familiarize yourself with the bankruptcy court's local rules and the assigned judge's chamber's rules. Keeping internal memos of these rules, backed by regular updates, will help reduce confusion as to what the court requires.

The Scope of Your Disclosures. The disclosures themselves should be detailed and specific. It is insufficient to make blanket disclosures. In fact, such generalized disclosures actually can backfire and lead the court to speculate that critical disclosures are being withheld. As noted above, should new connections arise during employment that did not exist at the time of the initial disclosures, the court must be notified immediately. As such, it is advisable practice to investigate for potential new connections at least quarterly, even if there is no reason to suspect that a new connection has formed.

Conclusion

Ultimately, it is the professional's burden to adequately disclose its connections under the auspices of the Bankruptcy Rules, the Bankruptcy Code, the Local Rules, and any Chamber's Rules. It is also essential to remember that a professional's obligation to disclose is ongoing.

Should you have any questions about a professional's disclosure obligations in bankruptcy cases, please feel free to reach out to:

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