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Second Circuit Changes the Game in *Alix v. McKinsey*

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It is a familiar scenario in the bankruptcy world: A financial advisor recommends a bankruptcy lawyer to Client A, and the bankruptcy lawyer, in turn, recommends the financial advisor to Client B. It is clear that in the world of restructuring professionals, reciprocity drives a significant number of business referrals. Far less clear is the extent to which such reciprocity must be disclosed.

The U.S. Court of Appeals for the Second Circuit's recent decision in *Jay Alix v. McKinsey & Co. Inc.*[1] examines whether a reciprocal referral arrangement (an alleged "pay-to-play" scheme) between a law firm and a restructuring advisory firm needed to be disclosed to the bankruptcy court in connection with the restructuring advisory firm's retention.[2] In holding that the U.S. District Court for the Southern District of New York failed to properly draw reasonable inferences in **Jay Alix**'s favor[3] when deciding McKinsey's motion to dismiss, the Second Circuit suggests that there may be a requirement to disclose reciprocal referral relationships.[4] While the Second Circuit revived Mr. Alix's complaint as a procedural matter, it did not determine the merits of the case. However, the decision presages a new playbook for reciprocity relationships in the restructuring world.

The subject of disclosure of reciprocal business relationships between firms is not a new one. Nondisclosure of a business relationship between bankruptcy professionals played prominently in *Ernst & Young LLP v. Devan (In re Merry-Go-Round Enterprises)*[5] almost 25 years ago.

Both *Alix* and *Merry-Go-Round* involve civil suits against a bankruptcy advisory firm arising from the failure to disclose a reciprocal referral relationship with a law firm.[6] Both plaintiffs sued on the premise that if the defendant firm had disclosed its relationship with the law firm representing the debtor, the defendant would not have been retained.[7] In *Merry-Go-Round*, the nondisclosure of reciprocal business relationships between a financial advisory firm and a law firm led to significant civil liability.[8] The Second Circuit's *Alix* decision gives Mr. Alix the chance to prove its claims that McKinsey violated the Racketeer Influenced and Corrupt Organizations (RICO) Act.[9]

Rules of the Game: Retention of Bankruptcy Professionals and Required Disclosures

Employment of a professional by the bankruptcy estate requires the bankruptcy court's approval.[10] Only professionals that "do not hold or represent an interest adverse to the estate" and are "disinterested persons" within the meaning of the Bankruptcy Code[11] may be employed as estate professionals.[12] Applications to retain estate professionals must be "accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditor, any other party in interest, their respective attorneys and accountants, the [U.S. Trustee], or any person employed in the office of the [U.S. Trustee]."[13] These disclosures must be submitted under penalty of perjury and are subject to the bankruptcy criminal statute.[14]

The term "connection" is not defined in the Bankruptcy Code. There is no bright-line test governing what constitutes a "connection." As a practical matter, the decision as to what connections require disclosure is left to the professional's discretion, who ultimately bears the risk of later disqualification, fee disgorgement or civil liability if the disclosure is later found to be deficient.[15] At a minimum, courts require the disclosure of

1 23 F.4th 196 (2d Cir. 2022). On March 30, 2022, the Second Circuit entered an order denying McKinsey's petition for panel rehearing or rehearing *en banc* of the referenced decision. Case No. 20-2548, Order.
2 *Id.* at 205-07, 209-10.
3 AlixPartners assigned each of the claims asserted in the action to Mr. Alix. *Id.* at 199.
4 *Id.* at 204.
5 222 B.R. 254 (D. Md. 1998).
6 *Id.* at 256; *Alix*, 23 F.4th at 200.
7 *Merry-Go-Round*, 222 B.R. at 256; Alix, 23 F.4th at 201.
8 *See* "Ernst to Pay $185 Million to Settle Suit," *N.Y. Times* (April 27, 1999), *available at* nytimes.com/1999/04/27/business/ernst-to-pay-185-million-to-settle-suit.html (unless otherwise specified, all links in this article were last visited on March 21, 2022).
9 *Alix*, 23 F.4th at 200.
10 *See* 11 U.S.C. § 327.
11 Section 101(14) of the Bankruptcy Code defines "disinterested person" as a person who:
(A) is not a creditor, an equity security holder, or an insider;
(B) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor; and
(C) does not have an interest materially 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.
12 11 U.S.C. § 327(a). Narrow exceptions to § 327(a) include: (1) a trustee (or debtor in possession) can retain a professional that has been employed by a creditor absent an actual conflict of interest (11 U.S.C. § 327(c)); and (2) lawyers who have previously represented the debtor may be employed as lawyers for a limited purpose (11 U.S.C. § 327(e)).
13 Fed. R. Bankr. P. 2014(a).
14 *See* 28 U.S.C. § 1746; 18 U.S.C. § 152(2)-(3).
15 *See, e.g., In re Begun*, 162 B.R. 168, 177 (Bankr. N.D. Ill. 1993) (affirmative duty to disclose connections with parties-in-interest and any adverse interests lies with professional seeking retention); *In re Marine Outlet Inc.*, 135 B.R. 154, 156 (Bankr. M.D. Fla. 1991) (same).

all financial, business and personal connections that may impact the retention.

Financial connections are the most direct connection, and thus the most apparent and readily identifiable. These primarily consist of the source of funding of a firm's retainer and payment of fees and expenses.[16] Business connections arise from a firm's current and prior representations or engagements, and are also clear-cut and identifiable. Similar to financial connections, courts have made it clear that business connections must be disclosed.[17] On the other hand, personal connections requiring disclosure include, at a minimum, close friendships and familial relationships.[18] Cases addressing bankruptcy professionals' disclosure requirements have raised the bar with respect to disclosure of "connections." However, it has left many questions unanswered, especially the troublesome question of whether reciprocity requires disclosure.

Does Reciprocity Constitute a "Connection"?

The *Merry-Go-Round* decision stands for the principle that an attorney/client relationship between the debtor's law firm and the debtor's financial advisory firm must be disclosed. On Dec. 1, 1997, the chapter 7 trustee for Merry-Go-Round instituted an action against Ernst & Young (EY) in the Circuit Court for Baltimore City alleging fraud, fraudulent concealment and malpractice in connection with EY's restructuring advice provided to Merry-Go-Round.[19]

The trustee alleged that EY failed to meet the standard of care for restructuring advisors in a chapter 11 case by staffing the case with inexperienced junior personnel who gave incompetent advice.[20] The complaint alleged that EY acted negligently in providing advisory services and that this negligence caused Merry-Go-Round's failure to reorganize successfully.[21] The trustee further alleged that in EY's retention papers filed with the bankruptcy court, EY failed to disclose its relationship with Merry-Go-Round's bankruptcy counsel, Swidler & Berlin, and that had the relationship between EY and Swidler been disclosed, Merry-Go-Round would not have retained EY.[22] EY was a significant client of Swidler, which was apparently the reason that Swidler recommended EY, despite EY's lack of retail restructuring experience at the time.[23]

The lawsuit filed against EY by the trustee was described as a "civil death penalty case" because of its existential implications for EY.[24] Ultimately, EY settled the suit for $185 million.[25] Following the *Merry-Go-Round* decision, uncertainty remains regarding when a reciprocal referral relationship must be disclosed. This is most recently apparent in *Alix*.

Alix v. McKinsey: "Pay-to-Play"

Mr. Alix, as assignee of AlixPartners LLP,[26] sued McKinsey & Co. Inc. and certain of its affiliates (collectively, "McKinsey") and several current or former McKinsey employees under the RICO Act and state law, alleging that McKinsey secured lucrative bankruptcy assignments by filing incomplete or false disclosures in bankruptcy court concerning McKinsey's conflicts of interest.[27] Mr. Alix alleges that this pattern of misrepresentations to the bankruptcy court resulted in injury to AlixPartners through the loss of engagements that it otherwise would have secured, as well as through the loss of the opportunity to compete for those engagements in an unrigged market.[28]

According to Mr. Alix, McKinsey's Rule 2014 filings constituted criminal fraud and predicate acts of racketeering activity under the RICO Act, which provides a private right of action to "[a]ny person injured in his business or property by reason of a violation" of the RICO Act.[29] Mr. Alix's theory is that McKinsey injured AlixPartners' business or property by reason of a RICO violation because McKinsey won business through filing fraudulent Rule 2014 statements, resulting in court approval to do work that would have otherwise been secured by AlixPartners.[30]

On Jan. 19, 2022, the Second Circuit reversed the district court's dismissal of Mr. Alix's complaint upon McKinsey's motion to dismiss, which found that the complaint failed to establish the requisite causal connection between McKinsey's alleged RICO violations and AlixPartners' injury.[31] The Second Circuit remanded the case for further proceedings.[32]

At the crux of Mr. Alix's allegations is McKinsey's failure to disclose a "pay-to-play" scheme, whereby it would agree to introduce clients to a law firm in exchange for the law firm exclusively recommending McKinsey to its clients.[33] Mr. Alix's complaint alleges that McKinsey offered to arrange exclusive meetings to introduce bankruptcy lawyers to high-level executives from McKinsey's most valued clients in exchange for exclusive referrals of bankruptcy assignments from those attorneys.[34]

Mr. Alix alleges that McKinsey's undisclosed "pay-to-play" scheme drove 13 engagements in extremely large

16 *See In re Park Helena Corp.*, 63 F.3d 877, 880-82 (9th Cir. 1995) (holding that debtor's counsel violated, among other provisions, Rule 2014, where counsel received $150,000 retainer from debtor's president and did not disclose source of retainer, and denying counsel's request for allowance of fees).

17 *See U.S. v. Gellene*, 182 F.3d 578, 581 (7th Cir. 1999) (debtor's counsel's failure to disclose its representation of debtor's secured creditor in connection with the debtor's pre-petition financing led to criminal conviction and incarceration of bankruptcy counsel); *KLG Gates LLP v. Brown*, 506 B.R. 177, 194-95 (E.D.N.Y. 2014) (law firm's boilerplate disclosure of 483 current and former clients that may have had conflicts with debtor was insufficient where debtor's counsel's disclosure did not reveal lead billing partner's personal role representing two creditors in unrelated bankruptcy cases, but finding debtor's counsel need not disclose his work with other bankruptcy professionals on prior cases or occasions); *In re Hot Tin Roof Inc.*, 205 B.R. 1000, 1004 (B.A.P. 1st Cir. 1997) (bankruptcy court determination to terminate debtor's counsel's employment in two cases, deny his employment application in third case, deny his fee application, and require disgorgement of fees already received was valid where he failed to adequately disclose connection with debtor and its insiders, his representation of another debtor, and adverse interests between debtors); *In re Leslie Fay Cos. Inc.*, 175 B.R. 525, 530, 536-39 (Bankr. S.D.N.Y. 1994) (debtor's counsel's failure to disclose its pre-petition representation of and relationships with board members and debtor's outside auditor, who could potentially be sued by the debtor, resulted in significant sanctions because relevant parties could potentially be sued by debtor, resulting in conflict).

18 *See In re El San Juan Hotel Corp.*, 239 B.R. 635, 639 (B.A.P. 1st Cir. 1999) (denying fees for counsel to successor chapter 7 trustee due to, *inter alia*, failure to disclose close friendship with counsel to previous trustee in litigation with successor trustee and his retention by previous trustee in separate bankruptcy case).

19 *Merry-Go-Round*, 222 B.R. at 256.

20 Elizabeth MacDonald, "Ernst & Young to Settle Merry-Go-Round Claims," *Wall St. J.* (April 27, 1999), *available at* wsj.com/articles/SB925172252917800164.

21 *Merry-Go-Round*, 222 B.R. at 256.

22 *Id.*

23 Elizabeth MacDonald & Scot J. Paltrow, "Ernst & Young Advised the Client but Not About Some Big Conflicts," *Wall St. J.* (Aug. 10, 1999), *available at* wsj.com/articles/SB934239482971051285.

24 Scott Shane & Jay Hancock, "Settlement with Ernst & Young Seen Near; Merry-Go-Round Trustee Seeks Billions over Bankruptcy Case," *Baltimore Sun* (April 20, 1999), *available at* baltimoresun.com/news/bs-xpm-1999-04-20-9904200256-story.html.

25 *See* "Ernst to Pay $185 Million to Settle Suit," *supra* n.8.

26 AlixPartners assigned each of the claims asserted in the action to Mr. Alix. *Alix*, 23 F.4th at 199.

27 *Id.* at 199-200.

28 *Id.* at 200.

29 *Id.* at 199-200 (quoting 18 U.S.C. § 1964(c)).

30 *Id.* at 201.

31 *Id.* at 200.

32 *Id.*

33 *Id.* at 201-02; *Alix v. McKinsey & Co.*, 404 F. Supp. 3d 827, 831 (S.D.N.Y. 2019), *vacated and remanded*, 23 F.4th 196 (2d Cir. 2022).

34 *Alix*, 404 F. Supp. at 831.

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cases, and had the details been disclosed to the bankruptcy court, McKinsey's retention would not have been approved.[35] The premise in the *Alix* and *Merry-Go-Round* cases is the same: If the defendants had made the proper disclosure, it would have never been retained.

When Do Reciprocal Referral Relationships Require Disclosure?

One important question faces every bankruptcy professional: What factors determine whether a relationship with another firm must be disclosed? *Merry-Go-Round* demonstrates why an attorney/client relationship between the debtor's law firm and debtor's financial advisory firm should be disclosed. However, *Merry-Go-Round* did not provide any bright-line test for determining when reciprocity requires disclosure. Therefore, the only approach that provides any certainty is to disclose any attorney/client relationship.

Cross-referral relationships (*i.e.*, where professional firms refer one another to clients, but are not themselves one another's clients) are less clear insofar as disclosure is concerned. Notably, the "pay-to-play" scheme in *Alix* went beyond the typical cross-referral relationships that commonly exist between and among lawyers and financial advisors in at least one important respect: McKinsey's arrangement with the law firm required that bankruptcy clients be referred to McKinsey *exclusively* in exchange for the introductions that McKinsey made to the law firm. The Second Circuit's ruling begs the question of whether exclusivity alone adds an element of *quid pro quo* that mandates disclosure, regardless of the size of the relationship.

35 *Alix*, 23 F.4th at 201.

Conclusion

Many questions remain unanswered following the Second Circuit's decision in *Alix*. The Second Circuit decision suggests that the possibility that AlixPartners might have won engagements was sufficient to withstand dismissal of the complaint, but Mr. Alix will need to prove more than a mere possibility in order to prevail at trial. Further case developments will determine whether Mr. Alix can demonstrate that McKinsey would not have won the engagements had its connections been disclosed.

While Mr. Alix's complaint alleges injury to a group of restructuring advisors, the complaint is brought only on behalf of AlixPartners, not a group. This deficiency could eventually prove fatal to the complaint and could obviate a decision on the merits. Nevertheless, a further decision in the case might address the question of whether reciprocity requires disclosure, if the court deems it necessary to answer that question.

Many firms have multiple, nonexclusive cross-referral relationships that are arguably "connections" in the ordinary sense of the word. *Alix* and *Merry-Go-Round* have left unanswered the question of whether any and all reciprocity — no matter how minor — requires disclosure. The eventual decision in *Alix* may provide clarity. abi