UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

In re	**Chapter 11**
GSC GROUP, INC., et al.,	**Case No. 10-14653-SCC** **(Jointly Administered)**
Debtors.	

MEMORANDUM OF LAW IN SUPPORT OF OBJECTION OF THOMAS LIBASSI, PHILIP RAYGORODETSKY, SETH KATZENSTEIN AND NICHOLAS PETRUSIC TO CAPSTONE ADVISORY GROUP, LLC'S AMENDED MOTION FOR A PERFORMANCE FEE

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Table of Contents

Page

TABLE OF AUTHORITIES

Page(s)

CASES

STATUTES

RULES

OTHER AUTHORITIES

PRELIMINARY STATEMENT

1. Thomas Libassi, Philip Raygorodetsky, Seth Katzenstein and Nicholas Petrusic, holders of general unsecured claims against the Debtors in an aggregate amount in excess of $2,230,000 (collectively, the "**GSC Creditors**"), by and through their undersigned counsel, respectfully submit this Memorandum of Law in Support of Objection of Thomas Libassi, Philip Raygorodetsky, Seth Katzenstein and Nicholas Petrusic to Capstone Advisory Group, LLC's Amended Motion for a Performance Fee (the "**Motion**") filed on June 8, 2012 [Dkt. No. 1412] (the "**Objection**"). In support hereof, the GSC Creditors respectfully represent as follows:

2. The instant Motion represents Capstone Advisory Group, LLC's ("**Capstone**") third attempt before the Court to obtain a success fee in these cases. The requested $2.75 million success fee is on top of nearly $6 million in hourly fees that Capstone is seeking in its final fee application (the "**Fee Application**") [Dkt. No. 1431]. Capstone claims that it is entitled to a success fee under Bankruptcy Code section 330 as a result of "rare" and "exceptional" results produced by it in these cases stemming from its role in an auction for the Debtors' assets that culminated in a credit bid for substantially all of the Debtors' assets by the Debtors' secured lenders.

3. Discovery in respect of the Motion has revealed that what is truly "rare" and "exceptional" about Capstone's work in these cases is that for nearly two years Capstone hid – and at no point planned on disclosing – that it was party to a fee sharing agreement with an independent contractor with respect to fees it has collected from the Debtors and is seeking by way of the Motion. The independent contractor Capstone agreed to share fees with is an entity controlled by Robert Manzo – the individual billing the most amount of fees on this matter and who Capstone held out as an "Executive Director" of the firm. It is clear that as a result of Capstone's fee sharing agreement it is not entitled to any fees in this case, let alone a success fee.

4. First, Bankruptcy Code section 504 flatly prohibits a party that enters into a fee sharing agreement from collecting fees from a debtor's estate. In this case, Capstone has entered into a fee sharing agreement that provided incentives for parties to overbill the Debtors' estates and deprived the Debtors' of true fiduciaries. During the course of its nearly two-year engagement on this matter, Capstone hid this agreement from the Court and parties in interest through numerous false and misleading certifications to the Court.

5. Second, in entering into this secret fee sharing arrangement, Capstone failed to determine whether it was truly "disinterested" in these cases under Bankruptcy Rule 2014. Capstone's failures in this regard also prevent it from collecting any fees from the Debtors.

6. Third, per the very terms of Capstone's engagement did not authorize it to delegate core services to third parties, charge the Debtors' estates for work performed by Manzo and certainly cannot mark-up or profit from Manzo's work as Manzo is an out-of-pocket expense of Capstone.

7. Fourth, Capstone's engagement of RJM constituted a material breach of the Engagement Letter (as defined below) and therefore, Capstone is not entitled to collect any fees from the Debtors' estates.

8. Fifth, even if the Court were to find that Capstone's section 504 violations are not an absolute bar to Capstone's fee request, it is clear that Capstone has not met its burden of demonstrating that a success fee is appropriate.

STATEMENT OF FACTS

9. Capstone had been serving as a financial advisor/investment banker to the Debtors for nearly 1½ years prior to the commencement of these bankruptcy cases. *See* Declaration of Robert Manzo in Support of the Debtors' Proposed Sale Procedures (the **"Manzo Declaration"**) [Dkt. No. 48]. In such capacity, Capstone (i) gained valuable insight into the

Debtors, (ii) understood that the Debtors were going to seek a prompt sale of their assets in bankruptcy and that a robust bidding process was likely without the need for extensive marketing efforts, (iii) formed a view as to the value of the Debtors' assets and the ability of the Debtors to satisfy their secured claims and (iv) was fully aware of the prospect of a secured lender credit-bid. *See id.* at 4-5, 8. According to Manzo, the "whole purpose of the Chapter 11 case was exclusively to immediately sell the company in a court-supervised 363 sale … ." *See* Declaration of Keith N. Sambur in Support of Memorandum of Law in Support of Objection to Request of Capstone Advisory Group, LLC for Payment of a Success Fee (the "**Sambur Decl.**"), Ex. B, at 13:7-10.

10. With this information in-hand, Capstone made a conscious decision to seek retention on an hourly-based fee arrangement rather than on a fixed monthly fee plus a negotiated performance or success fee basis. On September 1, 2010, the Debtors filed a motion seeking to approve Capstone as their financial advisor (the "**Employment Application**") [Dkt. No. 22] per the terms of an engagement letter annexed to the Employment Application (the "**Engagement Letter**"). Attached as Exhibit A to the Employment Application was the Declaration of Edwin N. Ordway, Jr. (the "**Ordway Declaration**"). Capstone's decision to seek an hourly compensation arrangement rendered the dual risk of deteriorating asset value (which Capstone believed was likely) and the prospect of a secured lender credit bid moot as it related to Capstone's compensation. *See* Manzo Declaration at 7-9. Through this arrangement, Capstone "locked-in" its down-side risk by bargaining for hourly compensation, but attempted to reserve its rights to seek a success fee so long as such a fee (i) was agreed upon with the Debtors and (ii) approved by the Court.

11. On October 7, 2010, the Court entered the Order, Pursuant to Section 327(a) of the Bankruptcy Code, Bankruptcy Rules 2014(a) and 2016(a) and Local Bankruptcy Rule 2014-1, Authorizing the Debtors and Debtors In Possession to Retain and Employ Capstone Advisory Group, LLC as Financial Advisor, *Nunc Pro Tunc* as of the Petition Date (the "**Retention Order**") [Dkt. No. 150]. Critically, the Retention Order, negotiated and agreed to by Capstone, provides that Capstone was to serve as a "327 professional" rendering any fees it seeks in these cases subject to Bankruptcy Court review under Bankruptcy Code section 330. *See* Retention Order. The Retention Order also provides "No success fee or bonus is being requested at this time or approved in connection with this Order; provided, however, that Capstone retains the right to seek approval of a success fee upon proper application pursuant to sections 330 and 331 of the Bankruptcy Code … ." Retention Order ¶ 8 (emphasis in original).

12. In the course of negotiating the terms of its Retention Order, Capstone also modified its scope of services agreeing to "Assist the Debtors in all aspects of the sale process under section 363 of the Bankruptcy Code … ." *See id.*, ¶ 2j; Engagement Letter at 1-2. Capstone would perform this service – as well as the other services it agreed to provide – on an hourly rate basis. *See* Sambur Decl. Ex. B, at 219:4-223:2.

13. On January 30, 2012, Capstone first filed its Motion for a Performance Fee (the **"Prior Motion"**). [Dkt. No. 1146]. In the Prior Motion, Capstone sought a success fee in the amount of $3.25 million (the **"Success Fee"**) in addition to the hourly fees and expense reimbursement sought which total in excess of $6 million.

14. A number of substantive objections were filed in response to the Prior Motion. The Office of the United States Trustee objected to the Success Fee (the **"Prior U.S. Trustee Objection"**) on the basis that Capstone, as a professional retained under Bankruptcy Code

section 327, had failed to provide evidence that (i) it should be awarded a success fee in addition to the hourly it bargained for and/or (ii) the hourly fees awarded did not represent reasonable compensation under prevailing case law. [Dkt No. 1230].

15. Despite these infirmities, Capstone pressed ahead and sought payment of the success fee at a hearing on February 29, 2012 (the **"February Hearing"**). At the outset of the hearing, counsel for the Trustee announced that the Trustee had reached an agreement in principal with Capstone regarding the fee, but cautioned that the Trustee was "not trying to steam roll anybody" and that if any party felt uncomfortable by the resolution for whatever reason their "arguments should be heard by the Court, and the Court should consider them." *See* Sambur Decl., Ex. F, at 7:21-8:9.

16. At the February Hearing, former Chief Judge Arthur J. Gonzalez expressed concern at Capstone's attempt to obtain a Success Fee in addition to its hourly fees and informed Capstone that he would issue a ruling as to whether or not an evidentiary hearing on the matter was necessary. *See id.* at 27:5-28:5, 36:6-14, 45:9-21, 52:4-53:10. Judge Gonzalez also cautioned that: "[Y]ou have to look at [the Success Fee request] in terms of the entire compensation package" which must take into account the fact that Capstone was "getting paid … as a result of … hours spent on" this case and not on a lower monthly fee basis and the ability to obtain a success fee "certainly is different" when a party has been paid on an hourly basis. *See id.* at 45:13-21.

17. Following the February Hearing, Capstone filed its Motion for an Order Pursuant to Bankruptcy Code § 105(A) and Bankruptcy Rule 9019 Approving Settlement Agreement between Chapter 11 Trustee James L. Garrity, Jr. and Capstone Advisory Group, LLC Regarding Performance Fee Motion (the **"Rule 9019 Settlement Motion"**) [Dkt. No. 1310]. Black

Diamond Capital Management, LLC, the United States Trustee and the GSC Creditors each filed objections to the Rule 9019 Settlement Motion [Dkt. Nos. 1381, 1382 and 1383].

18. On April 25, 2012, after a hearing on the Rule 9019 Settlement Motion, this Court denied the requests in the Rule 9019 Settlement Motion and directed Capstone to file an amended motion seeking a performance fee. Following that hearing, the parties took discovery.

19. Just prior to the beginning of a deposition of an apparent Capstone employee, Capstone produced documents which demonstrated that it had entered into an agreement to share fees received in this case (including any success fee) with an independent contractor, RJM, LLC ("**RJM**"). RJM is a limited liability company wholly-owned by Robert Manzo.

20. Discovery uncovered that, following Capstone's formation, it entered into a contractual relationship with Manzo with whom Ordway and the other Capstone co-founders had previously worked. *See* Sambur Decl., Ex. A, at 4:23-5:7, 13:7-15:21. Capstone at that time was struggling to attract business and wanted to use Manzo's reputation to grow the firm. *See* Sambur Decl., Ex. B, at 186:9-187:4. Ordway specifically recruited Manzo for this purpose, offering him a lucrative pay-package to join the firm. *See* Sambur Decl., Ex. A, at 14:10-15:6. However, Manzo refused to become an employee of Capstone. Rather, Manzo became an independent contractor to Capstone, agreeing with Capstone to share fees. *See id.*

21. Notwithstanding that arrangement – and apparently in order to burnish Capstone's reputation – Capstone held Manzo out as an employee of the firm, giving him the title of "Executive Director." *See id.* According to Manzo, it has always been clear to him that he was never an employee of Capstone. *See* Sambur Decl., Ex. B, at 193:16-19. And even Ordway now admits that Manzo was never an employee of Capstone. *See supra* ¶ 20.

22. Capstone and Manzo documented this arrangement by entering into a consulting agreement between Capstone and RJM, which was amended on February 19, 2009. A copy of the consulting agreement is attached as Exhibit C to the Sambur Decl. (the "**Consulting Agreement**"). RJM is a limited liability company with Manzo as its sole member. *See* Sambur Decl., Ex. B, at 202:3-24.

23. The Consulting Agreement, which was negotiated and executed by Ordway (Sambur Decl., Ex. A, at 92:2-95:8), provides as follows:

> The parties intent [sic] that an independent contractor-employee relationship will be created by this arrangement. Contractor [RJM] is not to be considered an employee of Capstone for any purpose, and the Contractor is not entitled to any of the benefits that Capstone provides for Capstone's employees. Contractor shall perform services under the direct supervision of Capstone's managers, Ed Ordway and Chris Kearns....

See Consulting Agreement § 1.

24. The Consulting Agreement further provides that Capstone would pay RJM (i) a $125,000 fixed monthly payment (the "**RJM Fixed Fee**"), (ii) 80% of the billable fees generated by RJM (the "**RJM Hourly Fees**") and (iii) incentive compensation (the "**RJM Incentive Payment**") based upon (A) growth in Capstone's total billable hours or (B) 15.5% of total revenues generated by Capstone applicable to all engagements that RJM manages for Capstone. *See* Consulting Agreement § 3. The Consulting Agreement also required each of RJM and Capstone to share 50% of all success fees or bonuses received by either of them on any matters in which RJM was actively involved in managing or instrumental in obtaining (the "**RJM-Capstone Success Fee**"). Manzo's billing rate is the highest at Capstone.

25. The Consulting Agreement does not require RJM to work exclusively for Capstone and, in fact, RJM has not worked exclusively for Capstone. *See id.* at § 5; Sambur Decl., Ex. B, at 187:6-19. Manzo has worked on numerous assignments through RJM for clients

other than Capstone or Capstone's clients. *See* Sambur Decl., Ex. B, at 172:20-175:9, 186:17-187:23. According to Manzo he "was working on a case-by-case basis depending upon the level of effort that [he] wanted to put forth, how much work [he] wanted to do with Capstone as well as some other assignments that [he] took on [his] own and for other people who called [him]." *See id.* at 187:7-13. Despite Capstone's understanding that Manzo had clients other than Capstone, Capstone did not run a conflicts check on behalf of RJM. *See* Sambur Decl., Ex. A, at 198:18-199:2. Manzo's conflicts check consisted of nothing more than asking himself whether RJM had a preexisting relationship with the Debtors. *See* Sambur Decl., Ex. A, at 200:21-202:13. He did not consider whether he or RJM had any preexisting relationship with the other parties to this bankruptcy proceeding. *See id.*

26. Following the August 31, 2010 petition date, RJM and Capstone twice amended the Consulting Agreement. *See* Sambur Decl., Exs. D & E. On November 22, 2010, Capstone and RJM amended the Consulting Agreement to provide that (i) the RJM-Capstone Success Fee earned on account of these cases, if any, would be shared "60/40" with 60% of such fees going to RJM and (ii) the RJM Incentive Payment would only be based upon the 15.5% of total revenues generated by Capstone applicable to all engagements that RJM manages for Capstone – such as the GSC engagement. *See* Sambur Decl., Ex. D, ¶¶ 2-3. In this amendment, Capstone also acknowledged that RJM provides services to entities other than Capstone. *See id.* at ¶ 4.

27. The second applicable amendment occurred on March 22, 2011 and modified RJM's compensation by eliminating the RJM Fixed Fee and increasing the RJM Hourly Fee to 100% of RJM's hourly fees generated. *See* Sambur Decl., Ex. E, ¶¶ 2-3. Ordway executed and negotiated each of these amendments. *See* Sambur Decl., Ex. A, at 94:13-95:8, 97:9-17; Exs. D & E.

28. According to both Capstone and Manzo, neither Manzo nor RJM has ever been a Capstone employee. *See* Sambur Decl., Ex. A, at 92:2-93:8; Ex. B, at 193:16-19.

29. Despite all of this and each of Capstone's and Manzo's clear understanding of the parties' relationship, in order to persuade the Court to approve Capstone's engagement, Ordway made the following sworn statement in the Ordway Declaration:

> To the best of my knowledge, (a) no commitments have been made or received by Capstone with respect to compensation or payment in connection with these cases other than in accordance with applicable provisions of the Bankruptcy Code and the Bankruptcy Rules, and (b) ***Capstone has no agreement with any other entity to share with such entity any compensation received by Capstone in connection with these chapter 11 cases***.

Ordway Declaration ¶ 17 (emphasis added).

30. On October 4, 2010, the Debtors filed a Supplemental Declaration of Edwin N. Ordway, Jr. in support of the Employment Application (the "**First Supplemental Ordway Declaration**") [Dkt. No. 142]. In that supplemental declaration, Ordway again made the following sworn statement:

> To the best of my knowledge, (a) no commitments have been made or received by Capstone with respect to compensation or payment in connection with these cases other than in accordance with applicable provisions of the Bankruptcy Code and the Bankruptcy Rules, and (b) ***Capstone has no agreement with any other entity to share with such entity any compensation received by Capstone in connection with these chapter 11 cases***.

Id. ¶ 18 (emphasis added).

31. Neither the Ordway Declaration nor the First Supplemental Ordway Declaration disclosed the fee sharing agreement with RJM. Ordway now admits in his recent deposition that these two sworn statements were false because Capstone is "sharing [compensation] with RJM" under their independent contractor agreement, although Ordway later tried to retract that testimony. *See* Sambur Decl., Exs. A, at 157:5-159:25, 213-14.

32. On October 6, 2010, the Debtors filed a Second Supplemental Declaration of Edwin N. Ordway, Jr. in support of the Employment Application (the "**Second Supplemental Ordway Declaration**" and together with the Ordway Declaration and the First Supplemental Ordway Declaration, the "**Retention Declarations**") [Dkt. No. 148]. In this declaration, Ordway mentions RJM for the first time. However, he mischaracterized the nature of the relationship, again concealing the independent contractor and fee sharing arrangement. Specifically, he represented to the Court as follows:

> It is my understanding that Robert Manzo, a professional staffed on this engagement, is the sole member of RJM, LLC. ***Mr. Manzo, through RJM, LLC, is an employee of, and works exclusively for, Capstone. No business is conducted by RJM, LLC except as described herein with respect to its employment by Capstone.*** None of the other Capstone employees staffed on this engagement has a similar employment structure.

Second Supplemental Ordway Declaration ¶ 15 (emphasis added). These statements were false when made: (i) neither RJM nor Manzo have ever been employees of Capstone; and (ii) neither Manzo nor RJM perform services exclusively for Capstone.[1]

33. Apart from mischaracterizing the RJM relationship, Ordway again concealed the fee sharing nature of that arrangement:

> To the best of my knowledge, (a) no commitments have been made or received by Capstone with respect to compensation or payment in connection with these cases other than in accordance with applicable provisions of the Bankruptcy Code and the Bankruptcy Rules, and (b) ***Capstone has no agreement with any other entity to share with such entity any compensation received by Capstone in connection with these chapter 11 cases***.

Id. ¶ 19 (emphasis added).

[1] Ordway offered no explanation as to why this language was included in the declaration and indicated that he satisfied himself as to its accuracy by asking Manzo if it was accurate. *See* Sambur Decl., Ex. A, at 46:13-17. Notably, however, both Ordway and Manzo both had no difficulty recalling at the time of their deposition that RJM was an independent contractor of Capstone. *See id.*at 14:6-15:6, 91:9-93:8; Ex. B, at 193:16-19.

34. Ordway testified that he thought "it was okay" to have "contractors working for me and working on engagements. I had been doing that for twenty years." See Sambur Dec., Ex. A, at 160:7-161:4. Ordway, however, also testified that he was aware that the law required estate professionals to make disclosures concerning fee sharing agreements. *See id.* at 161:5-18.

35. The Court, the GSC Creditors and all parties-in-interest had a right to know of the true nature of the Manzo-Capstone relationship nearly two years ago.. Had proper and adequate disclosures been made at that time, Capstone could not have sought any fees, let alone a success fee from the debtors.

ARGUMENT

I. Capstone's Violations of Bankruptcy Code Section 504 and Materially False and Misleading Disclosures Warrant Denial of The Performance Fee.

36. The Bankruptcy Code contains substantive and procedural safeguards for Debtors and their estates relating to professional compensation so as to ensure that estate professionals properly discharge their duties to the estate. Compliance with these safeguards is a prerequisite to receiving compensation from a debtor's estate.

37. Specifically, Bankruptcy Code section 504 provides:

> (a) Except as provided in subsection (b) of this section, a person receiving compensation or reimbursement under section 503(b)(2) or 503(b)(4) of this title may not share or agree to share—
>
> (1) any such compensation or reimbursement with another person; or
>
> (2) any compensation or reimbursement received by another person under such sections.
>
> (b) (1) A member, partner, or regular associate in a professional association, corporation, or partnership may share compensation or reimbursement received under section 503(b)(2) or 503(b)(4) of this title with another member, partner, or regular associate in such association, corporation, or partnership, and may share in any compensation or reimbursement received under such sections by

> another member, partner, or regular associate in such association, corporation, or partnership.

38. Violation of Bankruptcy Code section 504 operates as a complete bar to any shared compensation. See *In re Futuronics Corp.*, 655 F.2d 463, 471 (2d Cir. 1981) (disallowing fees entirely because of flagrant breaches of fee sharing disclosures); *In re Arlan's Dep't Stores, Inc.*, 615 F.2d 925, 933-34 (2d Cir. 1979) (law firm appointed as debtor's counsel that entered into an undisclosed fee sharing arrangement with another firm was not entitled to receive any compensation from the debtor's estate and ordered to disgorge fees previously paid); *In re ACandS, Inc.*, 297 B.R. 395 (Bankr. D. Del. 2003) (finding that subcontracting of claims processing to a subsidiary entity violated § 504); *In re Peterson*, Case No., 04-01469, 2004 Bankr. LEXIS 1275, *16-17 (Bankr. D. Idaho Aug. 25, 2004) ("It is thus a 'potential for harm' that supports absolute prohibition" of fee sharing and renders arguments of harm immaterial); *In re Matis*, 73 B.R. 228, 231 (Bankr. N.D.N.Y. 1987) (noting that Congress enacted § 504 to flatly prohibit fee sharing and preserve the integrity of the bankruptcy process and to ensure that estate professionals carry out their duties); *Rodriguez Quesada v. U.S. Trustee*, 222 B.R. 193 (D. P.R. 1998) (holding that use of attorneys who were independent contractors violated § 504).[2]

39. The uncontroverted record is clear: Capstone and RJM violated Bankruptcy Code section 504.[3] Capstone, a person that has received monthly compensation from the Debtors and is further requesting compensation by way of the Success Fee under Bankruptcy Code section 503, has at all times agreed to share and, has in fact shared, compensation received from the

[2] As, the Court entered the retention order based upon the false and misleading representations made in the Retention Declarations, the Court should reconsider entry of the Retention Order.

[3] By failing to disclose its fee sharing arrangement, Capstone further violated the requirements of Bankruptcy Rule 2014 which requires disclosure of "any proposed arrangement for compensation" in the application.

Debtors with another entity - RJM.[4] *See* Sambur Decl., Ex. A, at 98:10-100:2. The clear violations of Bankruptcy Code section 504 taint Capstone's entire engagement and prevent the award of any fees to Capstone – let alone a success fee.[5]

40. Furthermore, the failure to disclose the fee sharing agreement deprived the Debtors' estates of the important statutory protections afforded debtors and their creditors – namely Bankruptcy Code section 504 and Bankruptcy Rules 2014 and 2016. *See In re United Companies Financial Corp.*, 241 B.R. 521, 528 (Bankr. D. Del. 1999) (allowing estate professionals to subcontract engagements (even to affiliated entities) "eviscerates" the protections afforded by the code and deprives court of its duty to determine who may perform work for estate). By disregarding these statutory requirements and misleading the Court as to its compliance with such requirements, Capstone deprived the Debtors' estates of the fiduciary obligations enacted by Congress to protect the integrity of the bankruptcy system and creditors of bankrupt entities and delegated its responsibilities to the estate to an entity – RJM – that the Court did not appoint and owed no fiduciary duties to the Debtors.

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[4] In a letter sent to the Court on Friday, June 8, 2012, Capstone claims that it was permitted to share fees with Mr. Manzo under section 504 because he was purportedly a "member" of the firm. Capstone relies on *Lemonedes v. Balaber-Strauss*, 226 B.R. 131 (S.D.N.Y. 1998), a case holding that attorney who was held out as "of counsel" at a law firm counted as a "member" of the firm for purposes of a fee application. The narrow holding in *Lemonedes*, however, is based on the special status of "of counsel" attorneys at law firms which, the Court emphasized, owe fiduciary duties to their firms and, further, are fully disclosed. *See id.* at 132. By contrast, as an independent contractor, RJM, LLC held no fiduciary relationship with Capstone. And further unlike Lemonedes, the true relationship between RJM, LLC and Capstone was not disclosed until discovery on this motion. Lemonedes, therefore, is not contrary to case law holding that independent contractors do not count as "members" under section 504. *See, e.g., Webber, Reis, Holler & Urso, LLP v. Miller, Faignant & Behrens,* 2003 VT 65 (Vt. 2003); *see supra* p. 13, fn. 5.

[5] It is equally clear that Capstone violated Bankruptcy Rule 2016 which requires all parties filing an application for compensation to disclose any fee sharing arrangement when filing fee applications. Violation of Bankruptcy Rule 2016 is separate grounds for denial of a fee request. *See, e.g., In re Futuronics Corp.*, 655 F.2d at 471 (disallowing fees entirely because of flagrant breaches of fee sharing disclosures); *In re Peterson*, 2004 Bankr. LEXIS 1275, at *26; *In re ACandS*, 297 B.R. at 405 (stating that a court should punish willful failure to disclose Rule 2016 violations with full disgorgement of fees obtained); *In re United Companies Financial Corp.*, 241 B.R. 521, 529 (Bankr. D. Del. 1999) (denying request for fees resulting from undisclosed subcontracting agreement with affiliated entity); *In re Cupboards, Inc.*, 190 B.R. 969, 970 (Bankr. M.D. Fla. 1996) (requiring disgorgement of compensation for failure to disclose fee sharing arrangement and manipulation of invoices).

41. Indeed, the law has long prohibited fee sharing and for good reason:

> Whenever fees or other compensation are shared among two or more professionals, there is incentive to adjust upward the compensation sought in order to offset any diminution to one's own share. Consequently, sharing of compensation can inflate the cost of a bankruptcy case to the debtor, and therefore to the creditors.... The potential for harm makes such arrangement reprehensible as a matter of public policy ....

4 *Collier on Bankruptcy* P 504.01 at 504-3 (16th ed. rev. 2009)

42. In fact, Capstone's violation of Bankruptcy Code section 504 had real consequences as the fee sharing agreement created significant disincentives for each of RJM and Capstone to efficiently staff this engagement. Manzo received from Capstone 80% of all fees he billed to the Debtors through March 22, 2011 and 100% of all fees he billed thereafter. *See supra* ¶ 4. Because Manzo was in charge of this engagement for Capstone and his billing rate is higher than any other Capstone employee, Manzo had little incentive to delegate tasks to more cost-effective Capstone employees because such delegation would have resulted in substantially less fees for RJM than if Manzo did the work himself. *See id.*; Sambur Decl., Ex. A, at 13:7-20, 223:25-224:4. Given the vast number of hours billed by Manzo in these cases (426 hours in the month of December 2010 alone, not including 30 other hours that month which he billed to non-GSC matters) and the fact that Manzo billed approximately $2.6 million to the Debtors' estates (more than one-third the total fees sought by Capstone), this concern is not theoretical. *See* Fee Application.

43. Capstone too was incentivized to staff the GSC engagement with professionals with the highest billing rates. In addition to the foregoing, Capstone was obligated to pay RJM a guaranteed $125,000 payment each month until March 2011 and ***in addition*** 15.5% of all of Capstone's fees generated in the GSC engagement. Capstone's significant financial obligations

to RJM incentivized Capstone to generate significant billable hours each month in order for the engagement to be profitable for Capstone. For this reason, Capstone also had little incentive to question or alter Manzo's staffing choices and bill the estate efficiently.

44. Moreover, because RJM had no duty of loyalty to the Debtors, it could work with and for third-parties simultaneously as it was working on behalf of the Debtors. Such an arrangement was beyond the Court's, the Debtors' and creditors' expectations and taints the entirety of the Capstone engagement and therefore, all of Capstone's requested fees, including the claimed success fee.

45. Neither this Court nor any party in interest will ever fully know the impact the undisclosed RJM-Capstone fee sharing arrangement has had on these cases and Capstone's total fees requested. What we do know is that the Debtors and their estates were deprived of the statutory safeguards they are required to have and were purported to have received during these cases. *See In re Futuronics Corp.*, 655 F.2d at 471; *In re Arlan's Dep't Stores*, 615 F.2d at 933-34; *In re Peterson*, 2004 Bankr. LEXIS 1275, at * 26; *In re ACandS*, 297 B.R. at 405. Further, Capstone's actions worked to prevent the estates from obtaining the efficient and cost-effective representation required by the Bankruptcy Code. Accordingly, by any standard of reasonableness, Capstone has unsuccessfully carried out its duties as an estate professional and cannot now seek a "success fee."

II. The Fees Cannot Be Allowed Given Inadequate Conflicts Checks

46. Transparency and full disclosure from connections that taint the appearance of disinterestedness is also a central hallmark of bankruptcy court approval of retention of estate professionals. Indeed, Bankruptcy Rule 2014 is designed to assure not only integrity in fact, but the appearance of propriety. *In re Ira Haupt & Co.*, 361 F.2d 164, 168 (2d Cir. 1966) ("The conduct of bankruptcy proceedings not only should be right but must seem right."); *In re*

Mercury, 280 B.R. 35, 54 (Bankr. S.D.N.Y. 2002); *In re Lar Dan Enter., Inc.*, 221 B.R. 93, 95 (Bankr. S.D.N.Y. 1998) (noting that disinterestedness is vital to ensure that professionals tender undivided loyalty to the estate); *In re Granite Partners, L.P.*, 219 B.R. 22, 38 (Bankr. S.D.N.Y. 1998) ("Bankruptcy is concerned as much with appearances as with reality."); *In re Caldor, Inc.*, 193 B.R. 165, 171 (Bankr. S.D.N.Y. 1996) (stating that section 327 is intended to address the appearance of impropriety as much as its substance). It was incumbent upon Capstone to adequately disclose and comply with Bankruptcy Rule 2014 in advance of its retention by the Court.

47. Capstone did not run a "conflicts" or "disinterestedness" check for RJM. Manzo failed to run a proper check. *See supra* ¶ 25. Rather, RJM concluded it was disinterested because Manzo "had no business relationship with anybody at GSC." *See id.* Accordingly, Capstone had no basis to conclude it and Manzo were disinterested and there is no basis for determining that Capstone's Rule 2014 disclosure is true and correct.

48. Absent proof that the parties are truly disinterested, the Court cannot award the fees and expenses requested. *See, e.g., In re Crivello*, 134 F.3d 831, 839 (7th Cir. 1998) ("[A] bankruptcy court should punish a willful failure to disclose the connections required by Fed. R. Bankr. P. 2014 as severely as an attempt to put forth a fraud upon the court."); *In re Enron Corp.*, No. 01-16034 (AJG), 2002 WL 32034346, at *5 (Bankr. S.D.N.Y. May 23, 2002) ("[T]he professional must disclose all facts that bear on disinterestedness and cannot usurp the court's functions by selectively incorporating materials the professional deems important .... [f]ailure to disclose relevant connections is an independent basis for the disallowance of fees or disqualification from the case"), *aff'd*, 2003 WL 223455 (S.D.N.Y. 2003); *In re Midway Indus.*

Contractors, Inc., 272 B.R. 651, 663 (Bankr. N.D. Ill. 2001) ("[T]he punishment for intentional non-disclosure should be treated by the bankruptcy court as severely as a fraud upon the court.").

III. Capstone Cannot Charge Its RJM Expenses to the Estate

49. Because Manzo is not a Capstone employee, but rather an independent contractor, he constitutes an out-of-pocket expense of Capstone which it cannot profit from. Indeed, both the Retention Order and Engagement Letter do not permit Capstone to recoup this expense from the Debtors' estates.

50. The Retention Order provides:

> Capstone shall be reimbursed only for reasonable and necessary expenses as provided by the Amended Order Establishing Procedures for Monthly Compensation and Reimbursement of Expenses of Professionals, dated November 25, 2009, the Amended Guidelines for Fees and Disbursements for Professionals in the Southern District of New York, dated November 25, 2009, and the United States Trustee Fee Guidelines (collectively, the "**Fee Guidelines**").

Retention Order ¶ 4.

51. The Fee Guidelines do not contemplate reimbursement for independent contractors such as Manzo – and for good reason as their engagement must separately be approved by a court. *See also* 11 U.S.C. § 330(a)(1)(B) (professionals may only seek reimbursement of actual, necessary expenses). Capstone admits that it would not have completed work on this engagement without Manzo. *See* Sambur Dec., Ex. A, at 13:7-16. Accordingly, any "success fee" would result in pure profit to Capstone on account of its out-of-pocket expense – RJM.

52. Similarly, the Engagement Letter only permits Capstone to seek reimbursement for "reasonable out of pocket expenses." A multi-million dollar success fee being sought on account of work performed by an independent contractor cannot be considered a reasonable out-

of-pocket expense. Accordingly, even if the Court were to find that Capstone did not violate Bankruptcy Code section 504 and its related disclosure requirements, it is clear that Capstone cannot seek a success fee from the Debtors per the terms of its engagement.

IV. Capstone Breached the Engagement Letter by Allowing Manzo to Work on GSC Matters

53. The Engagement Letter provides that Capstone and not any other entity would be providing work for the Debtors' estate. *See* Engagement Letter at 1. The Debtors negotiated to have Capstone provide services on a "best efforts basis." *See id.* at 2. Capstone provided exceptions and exclusions to its contractual obligation, none of which include hiring an independent contractor who owed no fiduciary or direct contractual duty to the Debtors or their estates. *See id.* Capstone also represented that it had no interest adverse to the Debtors or the Debtors' estates. *See id.* at 3. The Debtors were also deprived of this protection by Capstone's use of Manzo and the failure to run appropriate conflicts checks. *See id.* at 3. Whereas Capstone had contractual and fiduciary obligations to the Debtors and their estates that the Debtors carefully bargained for, RJM's sole duty was to Manzo.

54. This deprived the Debtors of their bargained for agreement and constitutes a material breach by Capstone and a defense to payment under New York law – the law which governs the Engagement Letter. *See Dep't of Econ. Dev. v. Arthur Andersen & Co.*, 924 F. Supp. 449, 483 (S.D.N.Y. 1996) (stating that a breach is material if it "goes to the root of the contract" or is "so substantial and fundamental as to strongly tend to defeat the object of the parties in making the contract") (internal quotations and citations omitted); *Robert Cohn Assocs., Inc. v. Kosich*, 63 A.D.3d 1388, 1389 (3d Dep't 2009); 23 *Williston on Contracts* § 63:3 (4th ed. 1990) (noting that a material breach has occurred "if the promisee receives something substantially less or different from that for which he or she bargained.").

55. As set forth above, the fundamental nature of the Capstone-GSC relationship and GSC's bargain was altered by the RJM independent contractor and fee sharing agreement which shifted fee incentives and deprived the Debtors' estates and its creditors of a professional with fiduciary duties to the estate.

V. Capstone is Not Entitled to a Success Fee Under Bankruptcy Code Section 330

56. Even if this Court determines that Capstone's violations of Bankruptcy Code section 504 do not mandate denial of the Success Fee, Capstone is not entitled to payment of the Success Fee under Bankruptcy Code section 330.

57. The Retention Order clearly provides that Capstone must demonstrate that a success fee is allowable under the requirements of Bankruptcy Code section 330. *See supra* ¶ 11; Prior U.S. Trustee Objection at 18-24. Moreover, because Capstone was compensated on an hourly basis (at hourly rates of up to $950 per hour) for the very tasks that it now seeks an additional success fee in performing, Capstone must overcome the strong presumption that such hourly fees constituted reasonable compensation in relation to the tasks performed. *See supra* ¶ 12.

58. Under prevailing case law, even if Capstone could produce evidence sufficient to overcome this presumption, it would still have to demonstrate that a success fee is necessary to provide it with fair and reasonable compensation. *See, e.g., Perdue v. Kenny A.*, --- U.S.---, 130 S. Ct. 1662, 1673 (2010); *In re Enron Corp.*, No. 01-16034 (AJG), 2006 WL 1030421 (Bankr. S.D.N.Y. Apr. 12, 2006). As set forth in the Prior U.S. Trustee Objection, such fee enhancements are approved only in "rare" and "exceptional" circumstances and where the party has not otherwise been compensated based upon hourly fees charged. *See* Prior U.S. Trustee Objection at 21-23. As unsecured creditors are yet to see a distribution from the Debtors' estates it is clear Capstone cannot meet its burden.

A. Capstone Cannot Overcome the Strong Presumption Against Success Fees

59. Capstone attempts to justify its request for a Success Fee by comparing the Success Fee to a "transaction fee" typically part of investment banker retentions. Capstone then argues that its Success Fee, when added to the total hourly fees received in these matters is "reasonable." Capstone further justifies its requested Success Fee on the basis of:

(1) The extensive effort put forth in ensuring that the bidding procedures attracted as many bidders as possible.

(2) The "herculean effort" to contact bidders and get them to bid

(3) Creating the strategy to allow joint bids at the auction; and

(4) Requiring the last bid to be by silent bid.

60. However, Capstone's arguments overlook two crucial facts. First, Capstone was hired to perform these tasks and was adequately and handsomely paid for their work on these matters at rates up to $950 per hour. To date, Capstone's aggregate fees billed to the Debtors' estates exceed $6,000,000. The fact that Capstone performed these services at a high level is commensurate with the high hourly billing rates charged to the Debtors' estates and does not warrant an additional Success Fee.

61. Second, Capstone's Success Fee resembles nothing like a "reasonable" or "market" investment banking fee. In general, investment bankers receive modest monthly payments and take on the risk of the sale with the seller. If the sale exceeds expectations the banker will be well compensated and if the sale is below expectations the banker will only receive a modest fee. The bankers' monthly fees are often credited to some extent against the sale or transaction fee.

62. Capstone rejected out of hand this very sort of fee structure. *See* Sambur Dec., Ex. B., at 19:4-24:4. Capstone believed that an up-front flat or escalating success fee

arrangement was too risky to provide Capstone a meaningful fee. *See id.* Therefore, Capstone chose to be compensated as an hourly paid professional and in so doing took on no risk that the sale would be below expectations or merely meet the parties' expectations.

63. In this manner, had Capstone's "herculean efforts" yielded only a $10 million credit bid, Capstone was protected and would have earned its full hourly fee. Having made this choice, Capstone cannot now re-engineer the arrangement to provide a success fee absent overcoming the strong presumption that Capstone was reasonably well compensated for its time. It is clear that Capstone's fee structure – and thus its requested Success Fee – cannot be compared to the fees that investment bankers earn for taking on the risk of the sale.

64. Moreover investment banking fees are required to be fully negotiated up-front to prevent a party from requesting a backward-looking success fee. *See* Bankruptcy Rule 2014, Local Bankruptcy Rule 2014-1 ("An application for the employment of a professional person pursuant to §§ 327 and 328 of the Bankruptcy Code shall state the specific facts showing the reasonableness of the terms and conditions of the employment, including the terms of any retainer, hourly fee, or contingent fee arrangement."). Debtors and their creditors must know up-front what an estate will be charged for investment banking services so parties reasonable expectations are met. Here, the request is even more troublesome as Capstone (i) specifically chose to be paid on an hourly basis and not with a monthly fee, (ii) knew full well that the Debtors were going to seek a quick 363 sale and (iii) waited over six-months from the sale closing to first make a request for a success fee.

65. Allowing Capstone to sit back, watch market forces unfold and then claim that a credit-bid by the Debtors' secured lenders resulted *solely from its efforts* and entitle it to a success fee is entirely unreasonable on its face. Investment bankers take risk. Capstone took

none, but wants to be compensated as if it did. Its request for an after-the-fact success fee is entirely unreasonable.

B. Granting Capstone a Success Fee Will Harm Unsecured Creditors

66. Moreover, in examining whether the Success Fee is reasonable, this Court should examine the Success Fee in the context of the recoveries for unsecured creditors and determine whether granting the Success Fee will harm unsecured creditors. In this case, unsecured creditors will clearly be harmed if the Success Fee is approved.

67. As stated in the Rule 9019 Settlement Motion, Capstone and the Trustee negotiated with the purchaser of the Debtors' assets for a pool of funds to be used to satisfy professional fees incurred, but not otherwise paid prior to closing (such as the proposed success fee). *See* Rule 9019 Settlement Motion ¶ 17. The amount in this pool equaled $10,344,502 – a large sum given that unsecured creditors who elected a cash recovery under the plan were only to receive their pro rata share of $6.6 million. Approximately $1.4 million remains in this pool. *See id.* To the extent funds outside of these reserve funds are used to pay the proposed success fee, creditors will be harmed as there will be fewer assets available to satisfy creditor claims.

68. Capstone's proposed solution to this problem is to utilize a newly discovered asset to compensate itself, *i.e.*, the Eckert/Frank Escrow Account (as defined in the Motion). As the Trustee and Capstone have conceded, however, the funds in this account are an asset of the Liquidating Trust. *See id.* at 7. If the funds in the Eckert/Frank Escrow Account are not a Trust Asset due to the fact that they were sold to the Designated Purchaser under APA 1 and APA 2 or otherwise, the proposed settlement nonetheless provides that Capstone would receive payment from other Trust Assets. *See id.* at 9-10. Pursuant to the Plan and Trust Agreement, Trust Assets

are to be liquidated solely for the benefit of the trust beneficiaries – the holders of general unsecured claims that have elected the Combination Cash Option or the Equity Option.[6]

69. Accordingly, if any Trust Assets are used to pay Capstone, (i) Trust Assets will not be used for the purposes provided for under the Plan as Capstone is not a Trust Beneficiary and (ii) Trust Assets will be diminished reducing funds available to pay unsecured creditors.

70. Capstone's success fee is even more troubling when one considers that unsecured creditors have not received *any of their cash distributions required to be paid under the plan.*

71. The payment of a success fee will negatively impact creditors and creditor recoveries and the settlement cannot be justified on the basis that it does not harm the Debtors' creditors.

[6]Section 4.2(c) of the Plan allowed unsecured creditors to elect one of three recoveries: (i) Upfront Cash Option (entitling the holder to a pro rata share of $6.6 million), (ii) Combination Cash Option (entitling the holder to a pro rata share of $5.6 million and Trust Units), or (iii) the Equity Option (entitling the holder to equity interests in Reorganized GSC). The Plan further provides that any Trust Interests that would have been allocated to unsecured creditors had they elected the Combination Cash Option will be transferred to Reorganized GSC.

WHEREFORE, the GSC Creditors respectfully request that the Court deny the relief requested in the Motion.

Dated: New York, New York
June 8, 2012

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