

*Failure to Comply Can Be Costly*

# Disinterestedness, Conflicts of Interest Are Pitfalls for the Unwary

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**A**part from individual states' rules regarding professional conflicts of interest, the U.S. Bankruptcy Code contains its own provisions governing this subject. The code requires professionals employed by a debtor, trustee, or creditors' committee to be "disinterested."<sup>1</sup> Reaching the correct conclusion as to whether a professional is disinterested is essential because, unlike state conflict rules, the Bankruptcy Code's requirement cannot be waived. Serious consequences can result if it is determined that a professional is not disinterested.

The Bankruptcy Code defines a "disinterested person." Among other criteria, it requires that a professional cannot have been "within two years before the date of the filing of the petition, a director, officer, or employee of the debtor."<sup>2</sup> In evaluating a potential professional, opinions vary about whether the focus should be on the individual or the firm.

In a 1995 Illinois case, for example, the debtor's proposed counsel was a Chicago law firm that had previously represented the debtor.<sup>3</sup> Beyond that, a partner at the firm had been the debtor's assistant corporate secretary for a 10-year period that ended two weeks before the filing of the debtor's petition. Despite this partner's contention that he was merely an "assistant" secretary and never took any action during his tenure, the U.S. District Court determined that he was an officer of the debtor.<sup>4</sup> Because he acted in this capacity within two years of the filing of the bankruptcy petition, the court ruled that the partner was not a disinterested person and therefore was disqualified from representing the debtor.

The court, however, did not disqualify his firm. Noting that Congress had provided for imputed disqualification in other circumstances, the court found that nothing in the Bankruptcy Code required the imputed disqualification of an entire firm due to the ineligibility of one of its attorneys.

The court considered whether as a result of the ineligible partner's prior affiliation with the debtor and the firm's prior representation of the company, the firm as a whole

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should be disqualified under the Bankruptcy Code for having interests "materially adverse" to the debtor's.<sup>5</sup> Finding that the ineligible partner resigned as assistant secretary, never actually performed any duties while assistant secretary and would not participate in the debtor's bankruptcy case, the court concluded that the firm's continued representation of its long-standing client "would not... raise even the slightest appearance of impropriety, let alone the material adverse interest required."<sup>6</sup>

On the other hand, a recent Delaware case had similar facts but produced an entirely different result.<sup>7</sup> The debtor's proposed counsel was a Boston law firm with a partner who had served as the debtor's corporate secretary within two years of the filing of the petition. After disqualifying the partner for

not being disinterested, the court turned its attention to the firm as a whole.

Even though the ineligible partner would not participate in the bankruptcy case — and regardless of any procedures the firm implemented to screen him from the case — the court held that the disqualification of one attorney as disinterested necessitated the disqualification of the entire firm.<sup>8</sup> "[H]aving one member's independence and disinterestedness impugned because he was an officer must equally affect the firm's independence and disinterestedness such that the firm must be disqualified under...the Code," the court said in its ruling.

Considering the disagreement among courts regarding the issue of imputed disqualification, professionals should be aware of the prevailing opinions in the jurisdictions relevant to their employment.

## Disclosure Requirements

Unlike the automatic disqualification required by the Bankruptcy Code if a professional is not disinterested, other conflicts, such as those under various states' rules and the Model Rules of Professional Conduct, can be waived. As soon as a professional is contacted about representing a debtor, trustee, or creditors' committee in a bankruptcy proceeding, a thorough "conflicts check" should be conducted to ascertain whether any conflicts of interest or potential conflicts exist. If any are found, a professional should obtain a waiver letter from the conflicting party. When obtaining such waivers, even a seemingly harmless limitation agreed upon by the professional and the conflicting party must be fully disclosed to the court.

In a recent Montana case,<sup>9</sup> the debtor's counsel recognized that the debtor's main secured lender was an existing client of the firm. Counsel sought and obtained from the lender a conflict waiver that contained a "no litigation" exception that specified that counsel would not represent the debtor in litigation directly adverse to the lender.

By the time the conflicts waiver was obtained, counsel had already filed an affidavit with the court in support of its application for employment by the debtor. The document disclosed that counsel also represented "[d]ebtor's primary pre-petition lender and one of the proposed [debtor-in-possession] DIP lender[s] herein." In this initial affidavit, as well as in subsequent amendments to it, counsel advised the court that it would "continue to review its connections with shareholders, creditors, potential creditors, and other parties in interest...[and] will notify the Court if any actual conflicts of interest or other significant connections are discovered in th[e] process."

If an unwaived conflict were found, counsel's employment application also contained a fallback plan that promised to use special conflict counsel and/or local counsel for such matters. Counsel advised the court of the conflict waiver, but neither counsel's application nor any of the amendments to it mentioned the waiver's "no litigation" exception. Even though the fallback plan was mentioned in counsel's application, neither the court nor the other parties ever formally approved of it.

The firm continued as the debtor's lead counsel in a number of contested matters and negotiations adverse to the lender. Among these were the negotiation of DIP financing with the lender, which included a fee carve-out for the debtor's counsel; various court proceedings regarding an asset sale and a bid procedure dispute; and a full-blown hearing regarding an emergency cash collateral dispute, which was subsequently appealed.

Almost a full year passed before the debtor's counsel notified the court of the no litigation exception in the lender's waiver, despite the continual disputes between the debtor and the lender. This disclosure was


made only after the filing of a liquidation plan and the debtor's counsel filing its final fee application.

Upon learning of the limitation to the lender's conflict waiver, the U.S. Trustee filed a motion to disqualify the debtor's counsel and vacate the order authorizing its employment. The court granted the motion, holding that counsel's failure to disclose the waiver's no litigation exception violated mandatory bankruptcy disclosure requirements and could not be excused for simply being unintentional.<sup>10</sup> Even though the disclosure requirement did not necessitate the filing of the actual waiver letter, it did impose a duty on counsel to disclose "all of its connections" with the lender to the court, not just to the debtor.

The court reasoned that the bankruptcy disclosure requirements "do not give the attorney the right to withhold information because it is not apparent to him or her that a conflict exists," because "[a]ll facts that may be pertinent to a court's determination of whether an attorney is disinterested or holds an adverse interest to the estate must be disclosed." The debtor's counsel, "[h]aving advised the Court in three declarations...that it has disclosed all 'potential conflicts,' 'continues to review' its connections, and 'will notify the Court if any actual conflicts of interest or other significant connections are discovered,'...was unarguably required to disclose [the lender's] exceptions to its conflicts waiver."

Based on that failure to disclose, the court, in a forceful exercise of its discretion, denied counsel's final fee application in its entirety and ordered that counsel disgorge all previously received fees.

### Safeguards

The bankruptcy landscape is full of pitfalls for the unwary. As a result, professionals must be sure to remain disinterested, obtain all necessary conflict waivers, make full disclosure to the court and, when all else fails, provide an effective method of dealing with unwaived conflicts. 

<sup>1</sup> 11 U.S.C. § 327(a) (applicable to debtors via 11 U.S.C. § 1107).

<sup>2</sup> 11 U.S.C. § 101(14)(D).

<sup>3</sup> *In re Capen Wholesale, Inc.*, 184 B.R. 547 (N.D. Ill. 1995).

<sup>4</sup> *Id.* at 550.

<sup>5</sup> *Id.* (citing *In re Creative Restaurant Management, Inc.*, 139 B.R. 902, 913-14 (W.D. Mo. 1992) and 11 U.S.C. § 101(14)(E)). See also 11 U.S.C. § 327 (requiring that counsel "not hold or represent an interest adverse to the [debtor]").

<sup>6</sup> *Id.* See also *Vergos v. Timber Creek, Inc.*, 100 B.R. 624 (W.D. Tenn. 1996) (reaching the same conclusions as the Capen court).

<sup>7</sup> *In re Essential Therapeutics, Inc.*, 295 B.R. 203 (Bankr. D. Del. 2003).

<sup>8</sup> *Id.* at 208-210 (comparing, *inter alia*, *Capen*, *In re Timber Creek, Inc.*, 187 B.R. 240 (Bankr. W.D. Mo. 1992) (*aff'd sub nom. Vergos v. Timber Creek, Inc.*, 100 B.R. 624), and *Creative Restaurant* with, *inter alia*, *In re Philadelphia Athletic Club*, 20 B.R. 328 (E.D. Pa. 1982), and holding that "a law firm is an association of individuals; the firm can only act through those individuals; and, therefore, the disqualification of one must be attributed to all").

<sup>9</sup> *In re Jore Corp.*, 298 B.R. 703 (Bankr. D. Mt. 2003).

<sup>10</sup> *Id.* at 724-727. See Fed. R. Bankr. P. 2014(a) ("[t]he [employment] application shall state ... to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors [and] any other party in interest ... 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 [and] any other party in interest...").

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