

**WHY PROFESSIONALS MUST BE INTERESTED IN
“DISINTERESTEDNESS” UNDER THE BANKRUPTCY CODE**

May 2005

**William H. Schrag
Mark C. Haut**

Morgan, Lewis & Bockius LLP

© 2005 Morgan, Lewis & Bockius LLP. All rights reserved.

TABLE OF CONTENTS

	Page
INTRODUCTION	1
APPLICABLE LAW CONCERNING DISCLOSURE OBLIGATIONS AND CONFLICTS OF INTEREST	1
A. General Policy Considerations.....	1
B. Required Disclosure Under Bankruptcy Rule 2014.....	4
C. Conflicts Under The Bankruptcy Code.....	13
(i) Code Provisions	13
(ii) What Is An Interest Adverse To The Estate?.....	15
D. Sanctions for Violations of the Bankruptcy Code And Rules	26
i) Disclosure Violations.....	26
ii) Disinterestedness and Adverse Interest Violations.....	28
CONCLUSION.....	33

**WHY PROFESSIONALS MUST BE INTERESTED IN
“DISINTERESTEDNESS” UNDER THE BANKRUPTCY CODE**

By William H. Schrag and Mark C. Haut¹

INTRODUCTION

Full disclosure and freedom from connections which taint the appearance of disinterestedness is the sine qua non of bankruptcy court approval of the retention of a professional by a debtor, a trustee, or a creditors’ committee. As law firms continue to grow and clients continue to consolidate, this issue needs to be considered carefully by parties who ultimately must seek court approval for their retention and payment of their fees.

As discussed below, even inadvertent violations of the rules will have an impact on the allowability and payment of fees and expenses. The extent of this impact often will be determined by the degree and timing of the disclosure of connections. Accordingly, the most important rule to remember is: disclose, disclose, disclose -- early and often!^{2/}

**APPLICABLE LAW CONCERNING DISCLOSURE
OBLIGATIONS AND CONFLICTS OF INTEREST**

A. General Policy Considerations:

The Bankruptcy Code (the “Code”)³ and the Bankruptcy Rules (the “Rules”)⁴ provide a framework within which professionals who seek to be retained by a debtor, a trustee, or a

¹ William H. Schrag is a partner and Mark C. Haut is an associate in the Finance & Restructuring Group of the New York office of Morgan, Lewis & Bockius LLP.

² As stated by Professor Jay Westbrook of the University of Texas Law School: “[d]isclosure should be like voting in Chicago - early and often. Disclose, disclose, disclose. It is hard to get in trouble if you follow that rule.” Should Milbank Tweed Be Required To Disgorge \$1.8 Million Fee?, 31 Bankr. Ct. Dec. 7, Sept. 16, 1997.

³ All references to the Bankruptcy Code refer to 11 U.S.C. §§101 et al., as amended.

⁴ All references to the Bankruptcy Rules refer to Fed. R. Bankr. P. 1001 et al., as amended.

creditors' committee must operate. Professionals must be "disinterested," "hold no interest adverse to the estate" and disclose all connections which may bear upon the foregoing. Bankruptcy Code §327(a) and Bankruptcy Rule 2014. These requirements are intended to assure that "all professionals appointed pursuant to Section 327(a) tender undivided loyalty and provide untainted advice and assistance in furtherance of their responsibilities." In re Crivello, 134 F.3d 831, 836 (7th Cir. 1998), quoting Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir. 1994); see also In re AroChem Corp., 176 F.3d 610, 621 (2d Cir. 1999); Beal Bank, S.S.B. v. Waters Edge Ltd. P'ship, 248 B.R. 668, 695 (D. Mass. 2000); In re Wheatfield Business Park LLC, 286 B.R. 412, 417-18 (Bankr. C.D. Cal. 2002); In re C&C Demo, Inc., 273 B.R. 502, 506 (Bankr. E.D. Tex. 2001).

Given the common fund nature of bankruptcy, these provisions are 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 El San Juan Hotel Corp., 239 B.R. 635, 647 (1st Cir. BAP 1999), quoting Rome v. Braunstein, 19 F.3d at 58 ("the test is neither subjective, nor significantly influenced by the court-appointed professional's 'protestations of good faith' ... but contemplates an objective screening for even the 'appearance of impropriety'"), aff'd, 239 F.3d 1347 (1st Cir. 2000); Beal Bank, S.S.B. v. Waters Edge Ltd. P'ship, 248 B.R. at 695, quoting In re Martin, 817 F.2d 175, 182 (1st Cir. 1987) ("The purpose ... is to 'prevent even the appearance of a conflict'"); In re Mercury, 280 B.R. 35, 54 (Bankr. S.D.N.Y. 2002); In re Lar Dan Ent., Inc., 221 B.R. 93, 95 (Bankr. S.D.N.Y. 1998) (disinterestedness is vital to ensure that professionals tender undivided loyalty to the estate); In re Granite Partners, 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. - NY,

193 B.R. 165, 171 (Bankr. S.D.N.Y. 1996) (Section 327 is intended to address the appearance of impropriety as much as its substance).

In furtherance of these policies and concerns, the disinterestedness and disclosure requirements are to be applied strictly and vigorously. See, e.g., In re Crivello, 134 F.3d at 839 (“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”); Rome v. Braunstein, 19 F.3d at 57; In re Jore Corp., 298 B.R. 703, 725 (Bankr. D. Mont. 2003), quoting In re Park-Helena Corp., 63 F.3d 877, 881 (9th Cir. 1995) (disclosure rules under the Code “are applied literally even if the results are sometimes harsh”); In re Hot Tin Roof, Inc., 205 B.R. 1000, 1003 (1st Cir. BAP 1997); In re Enron Corp., 2002 WL 32034346 at *5 (Bankr. S.D.N.Y. 2002) (“courts have ruled that Rule 2014 disclosures are to be strictly construed”), aff’d, 2003 WL 223455 (S.D.N.Y. 2003); In re Midway Indus. Contractors, 272 B.R. 651, 663 (Bankr. N.D. Ill. 2001) (“the punishment for intentional non-disclosure should be treated by the bankruptcy court as severely as a fraud upon the court”); In re Vebeliunas, 231 B.R. 181, 195 (Bankr. S.D.N.Y. 1999), appeal dismissed, 246 B.R. 172 (S.D.N.Y. 2000); In re 245 Assocs., LLC, 188 B.R. 743, 750 (Bankr. S.D.N.Y. 1995); In re Leslie Fay Co. Inc., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1995).

As important as these policies are, and as clear as the admonitions of strict compliance appear to be, there is nonetheless a lack of uniformity in identifying disabling conflicts. There is general agreement; however, that whether a conflict exists or adequate disclosure has been made must be determined on a case by case basis. See, e.g., Rome v. Braunstein, 19 F.3d at 58; Beal Bank, S.S.B. v. Waters Edge Ltd. P’ship, 248 B.R. at 696 (“[w]hether counsel has a conflict of interest is a case-specific inquiry that requires intensive fact finding”); TWI Int’l. Inc. v.

Vanguard Oil and Serv. Co., 162 B.R. 672, 675 (S.D.N.Y. 1994); In re Finao Corp., 2005 WL 419704 at *2 (Bankr. M.D. Fla. 2005) (“A determination as to whether an attorney represents an interest adverse to the estate involves a fact-specific analysis”); In re Condor Sys., Inc., 302 B.R. 55, 70 (Bankr. N.D. Cal. 2003) (“This court will not compare itself against the circumstances of other cases, but looks to the circumstances of this case in determining whether Rule 2014 was violated and if so, the appropriate sanction based on reasonable inferences from the facts presented”); In re Granite Partners; 219 B.R. at 41; In re Caldor, 193 B.R. at 171; In re Leslie Fay, 175 B.R. at 532.

B. Required Disclosure Under Bankruptcy Rule 2014:

The obligation of full disclosure is unambiguously set forth in Bankruptcy Rule 2014, which provides, in pertinent part:

The [retention] 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. (Emphasis added).

The implementation of this rule falls squarely upon the professional to be retained and the applicant moving for such retention. The court “has neither the obligation nor the resources to investigate the truthfulness of information supplied, or to seek out conflicts of interest not disclosed As a consequence, professionals employed for the estate are nearly self policed.” In re EWC, Inc., 138 B.R. 276, 280 (Bankr. W.D. Okl. 1992). Accord, In re Crivello, 134 F.3d

at 839; Rome v. Braunstein, 19 F.3d at 59; In re BH&P, Inc., 949 F.2d 1300, 1317 (3d Cir. 1991); In re Midway Indus. Contractors, 272 B.R. at 664; In re Granite Partners, 219 B.R. at 40; In re Tinley Plaza Assocs. L.P., 142 B.R. 272, 278 (Bankr. N.D. Ill. 1992).

Accordingly, a paramount obligation of the professional to be retained, and of the applicant moving for such retention (whether a debtor-in-possession, trustee or committee), is to provide full and complete disclosure to the court of all connections that the professional has with parties in interest in the case. In re Crivello, 134 F.3d at 836; In re Jore Corp., 298 B.R. at 726 (professional “did not have the right to pick and choose which connections were unimportant or trivial”); In re Tomczak, 283 B.R. 730, 735 (Bankr. E.D. Wis. 2002), quoting In re C&C Demo, Inc., 273 B.R. at 507 (“Professionals are not permitted to ‘pick and choose’ which disclosures are irrelevant or trivial”); In re Enron Corp., 2002 WL 32034346 at *5 (“the 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”); In re Midway Indus. Contractors, 272 B.R. at 662, quoting In re Granite Partners, 219 B.R. at 35 (It is not left to the discretion of the professionals to pick and choose those connections which they deem relevant to disclose; rather, they must disclose “all facts that bear on...disinterestedness...”); In re Granite Partners, 219 B.R. at 35 (professional must disclose all connections, not merely those which are perceived to be conflicts, “and cannot usurp the court’s function by choosing, *ipse dixit*, which connections impact disinterestedness and which do not”); In re 245 Assocs., LLC, 188 B.R. at 750 (“applicants and their professionals must strictly comply with Rule 2014, and the failure to disclose all connections provides a basis to disallow fees and

even disqualify the professional”); In re Leslie Fay, 175 B.R. at 533, 536. Indeed, in Leslie Fay, the court noted that:

the requirements of Fed. R. Bankr. P. 2014 are more-encompassing than those governing the disinterestedness inquiry under section 327. For while retention under section 327 is only limited by interests that are “materially adverse,” under Rule 2014, “all connections” that are not so remote as to be de minimis must be disclosed.

175 B.R. at 536 (quoting In re Rusty Jones, Inc., 134 B.R. 321, 345 (Bankr. N.D. Ill. 1991)).

Similarly, the Second Circuit has stated that:

Attorneys who seek appointment [in bankruptcy cases] . . . owe the duty of complete disclosure of all facts bearing upon their eligibility for such appointment. If that duty is neglected, however innocently, surely they should stand no better than if it had been performed. . . . If the rule is to have vitality and the evils against which it is aimed are to be eliminated, it should be enforced literally.

In re Arlan’s Dep’t Stores, Inc., 615 F.2d 925, 933 (2d Cir. 1979) (quoting In re Rogers-Pyatt Shellac Co., 51 F.2d 988, 992 (2d Cir. 1931)); see also In re Futuronics Corp., 655 F.2d 463, 469 (2d Cir. 1981); In re Condor Sys., Inc., 302 B.R. at 70 (“The disclosure requirements of Rule 2014 do not give the professional the right to withhold information because it is not apparent to the professional that a conflict exists”); In re Midway Indus. Contractors, 272 B.R. at 662, quoting In re Saturley, 131 B.R. 509, 517 (Bankr. D. Me. 1991) (“The disclosures must be explicit and complete. ‘Coy or incomplete disclosures which leave the court to ferret out pertinent information from other sources are not sufficient’”); In re Granite Sheet Metal Works, Inc., 159 B.R. 840, 845 (Bankr. S.D. Ill. 1993) (professional failed to disclose pre and post-petition representation of debtor’s principal shareholder on matters which were the subject of potential litigation by the debtor; held, Rule 2014 requires disclosure of all facts that may be relevant and “removes the decision of what information to disclose from the discretion of the

attorney...” and failure to disclose, by itself, may provide a sufficient basis to disqualify and disallow fees); In re Envirodyne Indus., Inc., 150 B.R. 1008, 1020 (Bankr. N.D. Ill. 1993) (“it is mandatory that professionals seeking to be employed disclose all connections with the debtor, debtor-in-possession, insiders, creditors, and their respective attorneys or accountants”).^{5/} Cf. In re El San Juan Hotel Corp., 239 B.R. at 647 (Rule 2014 does not require a professional to list “every past or remote connection with every party in interest.” The professional “must disclose those presently or recently existing [connections], whether they are of business or professional in nature, which could reasonably have an effect on the attorney’s judgment in the case”); In re Enron Corp., 2002 WL 32034346 at *5 (court rejected objector’s argument that the requisite

⁵ The facts of In re Envirodyne are instructive. The debtors sought to retain Cleary Gottlieb as bankruptcy counsel and submitted a disinterestedness affidavit of Cleary, which included a boilerplate statement that Cleary had represented creditors in the past and would likely represent them in the future in matters unrelated to the case. Id. at 1013. An unofficial creditors’ committee objected to the retention of Cleary on the grounds that it represented Salomon Brothers in the past in connection with matters directly implicated in the bankruptcy of Envirodyne, including an LBO of Envirodyne which was underwritten by Salomon, and that Cleary continued to represent Salomon on matters unrelated to the bankruptcy case. In addition, Salomon was (i) a major creditor; (ii) the holder of four of seven board seats; and (iii) a controlling equity holder. Id. at 1015-16.

The court rejected Cleary’s bid for retention, notwithstanding Cleary’s explanation that it did make full disclosure because it did not view the undisclosed relationships as material. The court stated:

It is mandatory that professionals seeking to be employed disclose all connections with the debtor, debtor in possession, insiders, creditors and their respective attorneys or accountants.... F. R. Bankr. P. 2014(a) leaves an attorney with no discretion to choose what connections are relevant or trivial to a §327(a) analysis and should or should not be disclosed. No matter how trivial a connection appears to the professional... it must be disclosed.

Failure to abide by the disclosure requirements is enough to disqualify a professional and deny compensation, regardless of whether the undisclosed connections are material or de minimis. . .

It is the court’s role, not Cleary, Gottlieb’s, to determine whether a disqualifying conflict of interest exists.

Id. at 1020-21. (Emphasis added).

disclosure under the Bankruptcy Code included “every conceivable interpretation of its connections and possible consequence resulting from the connections; as well as a prediction of the outcome of any litigation that may result from, or be related to, the referenced connection”).

It is not enough to provide general information. In Leslie Fay, *supra*, Judge Brozman rejected Weil Gotshal’s argument that its disclosure of certain connections to the audit committee of the debtor’s board of directors was sufficient. Since it was the court that was required to make the ultimate determination on disinterestedness, it was the court that had to have the information. 175 B.R. at 535. Moreover, the disclosure requirements are not satisfied with generalizations or boilerplate admonitions. Such generalizations, at best, cover inadvertent omissions of insignificant connections. They do not adequately disclose known or future connections, particularly with entities who are creditors, litigation targets or professionals associated with the debtor. In re Granite Partners, 219 B.R. at 34-36. In Leslie Fay, the court held:

The boilerplate language to the effect that Weil Gotshal may have in the past represented, currently represents, and may in the future represent entities which are claimants of the debtors was insufficient to alert the court to Weil Gotshal’s representation of a creditor which was high on the list of the debtors’ twenty largest creditors (from which list a creditors’ committee is normally selected). The boilerplate is reasonable to cover inadvertent failures to disclose insignificant connections; it is not an adequate substitute for disclosure of representation of known and significant creditors. To rule any other way would be to eviscerate the disclosure requirements of Rule 2014(a).

175 B.R. at 537. (Emphasis added). See also In re Maximus Computers, Inc., 278 B.R. 189, 196 (9th Cir. BAP 2002) (retention application noted that trustee’s proposed special counsel represented a creditor of the debtor, but failed to disclose the continuing relationship between creditor and counsel and that creditor was paying counsel’s fees; held, “the minimal recital relating to a material matter ... tendered to the court without supporting explanation does not

satisfy Rule 2014(a)"); In re Begun, 162 B.R. 168, 177 (Bankr. N.D. Ill. 1993) (conclusive statements that the professional holds no adverse interests are insufficient).

In addition to the requisite disclosure at the time a retention application initially is made, Bankruptcy Code §327(a) implies a continuing obligation upon the professional to immediately disclose connections which are either discovered subsequently or which arise subsequently during the course of the representation. Rome v. Braunstein, 19 F.3d at 57-58; In re Condor Sys., Inc., 302 B.R. at 70; In re Tomczak, 283 B.R. at 735 (“Full disclosure is a continuing responsibility on the part of the professional employed by the trustee. If potential conflicts arise after the attorney has been appointed for the trustee, the attorney is under a duty to promptly notify the court”); In re Carolina Premier Med. Group, P.A., 2001 WL 1699220 at *1 (Bankr. M.D. N.C. 2001); In re Granite Partners, 219 B.R. at 35; In re CF Holding Corp., 164 B.R. 799, 806 (Bankr. D. Conn. 1994); In re Tinley Plaza Assoc., 142 B.R. at 278; In re Diamond Mortgage Corp., 135 B.R. 78, 89 (Bankr. N.D. Ill. 1990).

Although it is not unreasonable to conclude that the burden of full disclosure rests primarily with the professional, the applicant (whether debtor, trustee or committee) is not absolved of the obligation to apprise the court of connections which the professional holds and which are known to the applicant. Rule 2014(a) requires the applicant to separately certify that no disqualifying conflicts exist. In re El San Juan Hotel Corp., 239 B.R. at 640 (successor trustee disqualified because he failed to notify the court of his attorney’s business and personal relationship with the original trustee, who the successor trustee proposed suing for mismanagement of the estate); In re Enron Corp., 2002 WL 32034346 at *5 (“[t]he process places a burden upon the applicant to disclose and a burden upon the United States Trustee, and other parties in interest, to raise their concerns in a timely manner”); In re Granite Partners, 219

B.R. at 45 (trustee had obligation to disclose connections that he knew or should have known about); In re Blinder Robinson & Co., 131 B.R. 872, 881 (D. Colo. 1991) (both the trustee and his prospective professional have an “affirmative duty to disclose any potential conflicts”); In re Rea Holding Corp., 2 B.R. 733, 736 (S.D.N.Y. 1980) (interpreting In re Arlan Dep’t Stores, 615 F.2d at 932 (2d Cir. 1979)); In re 245 Assocs., LLC, 188 B.R. at 750.

In Blinder, *supra*, the trustee failed to disclose that his counsel represented a party suing the debtor. A creditor objected to the appointment of the trustee and trustee’s counsel on the ground that they held an interest that was materially adverse to the estate. The court noted that the trustee and counsel were not forthright in disclosing the potential problem, which in itself “presented an appearance of impropriety.” *Id.* at 881. In addition, the court noted that the trustee was aware of the problem, but determined on his own that it did not affect his or counsel’s disinterestedness. The court stated that:

such an exercise in *ipse dixit* is not permissible. That the trustee internalized this decision rather than presenting the relevant information to the court and other parties for an objective determination of disinterestedness suggests that the trustee is selective about the information he provides to the court and fails to acknowledge the high fiduciary standard to which he must abide to the point of *punctilio*.

* * *

[E]arly, full disclosure of all potentially adverse interests should be a principle of first magnitude in all such cases and . . . the decision regarding the degree of conflict and disinterest should be made by the judge based upon such full disclosure and the responses from interested parties which would ensue therefrom.

Id. at 883. (Emphasis added).

Further, in In re Micro-Time Mgmt. Sys., Inc., 102 B.R. 602, 608 (Bankr. E.D. Mich. 1989), the court invalidated the retentions of both the trustee and his accountants, holding:

Bohl did not disclose his potentially disqualifying relationship with Comerica in either the trustee's declaration of disinterest or in the affidavit he submitted when he applied for approval to appoint Parker, Bohl & Associates as accountants for the trustee. Instead, Bohl swore in his affidavit that "To the best of my knowledge neither our firms or any member thereof . . . holds any interest adverse to the matters upon which we are to be engaged. Neither I nor any member of my firm has any relationship or interest in the above named debtor or any other parties of interest therein." These statements were false; Bohl had an ongoing relationship with Comerica.

The fact that he questioned Schafer about whether his work for Comerica presented a conflict of interest indicates that Bohl was concerned about the issue. As the court stated in In re Gray, [64 B.R. 505 (Bankr. E.D. Mich. 1986),] "If the applicant had any doubt on the point it should have disclosed the claim and sought a ruling." Id. at 508. Instead, the Court, the U.S. Trustee, and any other interested party was denied the opportunity to make an informed evaluation of the applicants' qualifications. And, as the U.S. Trustee stated at the hearing on this matter, Bohl and Parker, Bohl & Associates may not have been appointed if the appropriate disclosures had been made.

Id. at 608.

This dual certification requirement obligates the trustee to do more than accept at face value the professional's disclosures to the court, particularly where there are facts within the trustee's knowledge which have a bearing upon such disinterestedness. In re Granite Partners, 219 B.R. at 45; 9 Colliers on Bankruptcy ¶ 2014.03, at 2014-6 (15th ed. rev. 2003) ("[t]he better practice is to approach an application under Rule 2014 as a pleading which merits careful preparation and review and to err on the side of over-disclosure").

Although it may be desirable for the client to be able to rely on his counsel as to what is or is not required to be disclosed pursuant to Rule 2014, the Rule imposes an independent obligation on the applicant. If the applicant is able to avoid all responsibility for disclosure, notwithstanding actual knowledge of connections involving the professional sought to be

retained, merely by accepting applicant's counsel's form of application, then the Rule itself is rendered meaningless. As stated by the court in In re Rusty Jones, Inc., 134 B.R. at 345, "there is no merit to the ... argument that [a party] did not have to disclose its connections ... because its attorneys did not feel that a conflict existed." See also In re Smith, 170 B.R. 111, 116-17 (Bankr. N.D. Ohio 1994) (and cases cited therein) (rejecting reliance on the advice of counsel as a defense to contempt charges for alleged willful violations of the automatic stay).

Indeed, in In re Granite Partners, 219 B.R. at 45, the trustee knew that his counsel, Willkie Farr, could not sue Price Waterhouse, an identified litigation target. Nevertheless, the trustee did not disclose this fact to the court in his application or require such disclosure in Willkie Farr's own application. The court found:

The trustee broke the cardinal principle of Rule 2014(a). He arrogated to himself a disclosure decision that the Court must make. Rule 2014(a) required, even in the absence of an investigation, that the trustee disclose Willkie Farr's connections with the debtors' accountants. Here, the need for disclosure went further. The trustee knew that Price Waterhouse was a target of his own investigation. He should have understood the improper perception created by Willkie Farr investigating any accountant in light of its association with the AICPA and its policy of not suing accountants. He nevertheless decided, on his own, that the connection was not a conflict, and the refusal to sue was not an obstacle, and he concluded that he did not have to disclose it. He made a decision that was never his to make in the first place, and reached the wrong conclusion when he did.

Cf. LNC Invs., Inc. v. First Fidelity Bank, N.A., 1997 WL 528283 (S.D.N.Y. August 27, 1997) (under New York law, a fiduciary may rely upon the advice of counsel in connection with open or unresolved issues of law if complete disclosure of all facts was made to counsel, the advice was actually relied upon and the reliance was reasonable based upon how a prudent person under similar circumstances would have acted).

C. Conflicts Under The Bankruptcy Code:

(i) Code Provisions:

The Code does not define a conflict of interest. Instead, as more fully discussed below, the statutory language refers to professionals who hold an interest adverse to the estate and are not disinterested. The inconsistency between Code §327(a), which refers to “an interest adverse to the estate” and Code §101(14)(E), which refers to “an interest materially adverse to the interest of the estate” adds to the confusion of what constitutes an adverse interest.

The framework for a trustee’s employment of professionals in a bankruptcy case is set forth in several sections of the Code.⁶ Section 327(a) provides:

Except as otherwise provided in this section, the trustee, with the court’s approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee’s duties under this title. (Emphasis added).

The definition of “disinterested person” is set forth in Code Section 101(14). The statute defines “disinterested person” as a person that:

(A) is not a creditor, an equity security holder, or an insider; (B) is not and

⁶ These rules also apply to the appointment of crisis managers who are often employed pre-petition to assist in a turnaround or liquidation. Court authorization is required to employ a crisis manager post-petition and the disinterestedness requirements contained in Section 327(a) must be satisfied. This can prove problematic when the crisis manager served as a pre-petition officer or director or is a creditor of the estate. Under such circumstances, courts often find that the crisis manager fails the disinterested requirement of Section 327(a) and deny the retention application. See e.g., In re Capitol Metals Co., Inc., 228 B.R. 724, 727 (9th Cir. B.A.P. 1998) (pre-petition CFO could not be retained post-petition as a financial advisor because the former CFO was not disinterested). However, if the crisis manager is employed in the ordinary course of business, court authorization may not be required and the disinterestedness requirements may be circumvented. Section 363(c) allows a trustee or debtor in possession to enter into transactions in the ordinary course of business without court authorization. The transaction must be common in the industry and meet creditor’s expectations to satisfy the “ordinary course of business” test. Since the retention of crisis managers may not be commonplace, Section 363(c) will only be applicable in limited situations (such as in certain industries that are prevalent in bankruptcy filings).

was not an investment banker for any outstanding security of the debtor; (C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor; (D) 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 or of an investment banker specified in subparagraph (B) or (C) of this paragraph; and (E) 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 an investment banker specified in subparagraphs (B) or (C) of this paragraph, or for any other reason. 11 U.S.C. §101(14) (2003) (emphasis added).⁷

Thus, in addition to the specific and objective criteria contained in Code Section 101(14)(A)-(D), the catch-all provision of Code Section 101(14)(E) utilizes the otherwise undefined term “adverse interest” and adds an element of materiality to the mix:^{8/}

Code Section 328(c), which governs compensation of professionals, also is relevant and provides:

Except as provided in section 327(c), 327(e) or 1107(b) of this title, the court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under section 327 or 1103 of this title if, at any time during such professional person’s employment under section 327 or 1103 of this title, such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed.^{9/} (Emphasis added).

⁷ The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, signed by President Bush on April 20, 2005, redefines “disinterested person” to repeal the per se conflict-of-interest provisions that disqualified the debtor’s pre-bankruptcy investment banker, and any attorney for such investment banker, from continuing advisory services as part of the debtor’s bankruptcy proceedings. This section will become effective 180 days after its enactment and, therefore, applies only to cases commenced on or after October 17, 2005.

⁸ The legislative history for the Bankruptcy Code does not further define what is meant by the clause “interest materially adverse.” See H.R. Rep. No. 595, 95th Cong. 1st Sess. 310-11 (1977); S. Rep. No. 989, 95th Cong. 2^d Sess. 23 (1978).

⁹ The exceptions referred to in the statute are not applicable herein.

Code Section 328(c) clearly requires that both prongs of Code Section 327(a) -- disinterestedness and no adverse interest -- be satisfied at all times throughout the course of the professional's employment. In re Crivello, 134 F.3d at 836; Rome v. Braunstein, 19 F.3d at 60; In re Angelika Films 57th, Inc., 227 B.R. 29, 39 (Bankr. S.D.N.Y. 1998) ("the duty to avoid conflicts is ongoing"), aff'd, 246 B.R. 176 (S.D.N.Y. 2000); In re Granite Partners, 219 B.R. at 32; In re Benjamin's Arnolds, Inc., 1997 WL 86463 at *5 (Bankr. D. Minn. 1997); In re Caldor - NY, 193 B.R. at 171; In re CF Holding, 164 B.R. at 805.

(ii) **What Is An Interest Adverse To The Estate?**

Several lines of cases have evolved which deal with this issue in different ways -- imposing per se rules, or formulating a balancing test which incorporates the materiality of the adverse interest. Nonetheless, it is universally agreed that the existence of an actual, as opposed to a potential, conflict disables a professional from being retained. Code §327(a); See, e.g., Woods v. City Nat'l Bank & Trust Co. of Chicago, 312 U.S. 262, 268 (1940); In re Woodworkers Warehouse, 303 B.R. 740, 742 (Bankr. D. Del. 2004) ("Section 327(a), as well as section 327(c), imposes a per se disqualification as trustee's counsel of any attorney who has an actual conflict of interest"). The distinction between these two conflicts has been described as follows:

"Actual" conflict occurs when the professional serves two presently competing and adverse interests. In re Diamond Mortgage, 135 B.R. at 91. "Potential" conflict is said to occur where the competition does not presently exist, but may become active if certain contingencies arise. In re BH&P, Inc., 103 B.R. at 363.

In re American Printers & Lithographers, 148 B.R. 862, 866 (Bankr. N.D. Ill. 1992). Problems arise, however, in determining when a potential conflict constitutes an adverse interest. In Leslie Fay, supra, the Court noted:

The Code does not attempt to define what constitutes an adverse interest. However, interests are not considered “adverse” merely because it is possible to conceive a set of circumstances under which they might clash. The more difficult area is when a live conflict of interest has not quite emerged, yet the factual scenario is sufficiently susceptible to that possibility so as to make the conflict more than merely “hypothetical or theoretical.” The courts have been far from uniform in the way they have formulated tests for dealing with this type of situation.

175 B.R. at 532. See, e.g., In re Federated Dep’t Stores, Inc., 44 F.3d 1310, 1319 (6th Cir. 1995) (“Congress sought to disqualify professionals with the appearance of a conflict of interest as well as those who have an actual conflict”); In re BH&P, Inc., 949 F.2d at 1310 (disinterestedness covers not only actual conflicts, but also the appearance of impropriety); In re Woodworkers Warehouse, 303 B.R. at 742 (proposed counsel disqualified for *potential* conflict where debtor defaulted on an obligation to a former client of such counsel in a prior bankruptcy case, which default precipitated that former client’s bankruptcy filing); In re Premier Farms, L.C., 305 B.R. 717, 720 (Bankr. N.D. Iowa 2003) (“Although there is a *per se* disqualification for an actual conflict of interest, the court in its discretion, may disqualify an attorney that has a potential conflict”); In re TWI Int’l, 162 B.R. at 675 (counsel for the debtor also represented a principal of the debtor, both pre and post-petition; held, the relationship between the debtor and its principal placed counsel in a position of “potential actual conflict” since he had the ability to lessen the value of the bankruptcy estate); In re O.P.M. Leasing Servs., Inc., 16 B.R. 932, 941 (Bankr. S.D.N.Y. 1982) (mere allegation of a conflict of interest, particularly where there is no actual or potential injury to the estate or its creditors, does not constitute a disabling adverse interest).

Some courts find that only actual conflicts of interest rise to the level of “an interest adverse to the estate” which precludes retention under Code §327(a). See, e.g., H&K Developers v. Waterfall Village of Atlanta, Ltd., 103 B.R. 340, 345-47 (Bankr. N.D. Ga. 1989) (counsel’s current and prior representation of an entity, which through a chain of related entities

owned the debtor, on matters unrelated to the bankruptcy, presented only a potential -- non-disqualifying -- connection); In re Stamford Color Photo, Inc., 98 B.R. 135, 138 (Bankr. D. Conn. 1989) (“merely hypothesizing that conflicts may arise is not a sufficient basis to warrant . . . disqualification”).

Other courts adopt a per se approach, rejecting any distinction between actual and potential conflicts. These courts hold that any connection which creates an appearance of impropriety constitutes an actual conflict of interest which precludes a professional’s retention under Code §327(a). See, e.g., In re Interwest Bus. Equip., Inc., 23 F.3d 311 (10th Cir. 1994) (affirming bankruptcy court ruling that representation of multiple, related debtors with inter-company claims constitutes a disabling conflict, regardless of the materiality or the potential for actually asserting such claims); Beal Bank, S.S.B. v. Waters Edge Ltd. P’ship, 248 B.R. at 695, quoting In re Martin, 817 F.2d at 182 (“an inquiry does not have to ask ‘whether a conflict exists . . . but *whether a potential conflict, or the perception of one* renders the lawyer’s interest materially adverse to the estate or the creditors’“); In re Kendavis Indus. Int’l, Inc., 91 B.R. 742, 754 (Bankr. N.D. Tex. 1988) (“Once there is a conflict, it is *actual — not potential*”); In re Roger J. Au & Son, Inc., 64 B.R. 600, 605 (N.D. Ohio, 1986) (representation of debtor-in-possession and debtor-in-possession’s principal shareholder, who also was a guarantor, required disqualification based upon the danger of shifting loyalties and “a reasonable possibility of the occurrence of [a] specifically identifiable appearance of improper conduct . . .”).

It is apparent that the “appearance of impropriety” approach is based, at least in part, upon various principles of legal ethics governing attorney conduct. In re Freedom Solar Ctr., Inc., 776 F.2d 14, 16 (1st Cir. 1985); In re Lee Way Holding Co., 102 B.R. 616, 622 (S.D. Ohio 1988); In re Kendavis Indus. Int’l, supra. For example, Canon Five of the New York Code of

Professional Responsibility requires an attorney to exercise independent professional judgment on behalf of a client. The related Disciplinary Rule 5-105 addresses potential multiple representation as follows:

In the situations covered by DR 5-105(A) and (B), a lawyer may represent multiple clients if it is obvious that the lawyer can adequately represent the interest of each and if each consents to the representation after full disclosure of the possible effect of such representation on the exercise of the lawyer's independent professional judgment on behalf of each.

While these rules discourage an attorney from placing himself in a position of having to choose between conflicting loyalties, they permit the attorney to obtain waivers from his or her client or clients as may be necessary to permit conflicting representations. However, in the bankruptcy arena, additional considerations become applicable. Courts enforce the more stringent requirements of the Code, prohibiting multiple representations where there are conflicts, even if waived. In re Granite Partners, 219 B.R. at 34 (“the mandatory provisions of section 327(a) do not allow for waiver”); In re American Printers & Lithographers, 148 B.R. at 867 (conflict waivers are irrelevant in a bankruptcy case); In re Tinley Plaza Assocs., 142 B.R. at 278 (requirements of the Code are more stringent than ethics rules and cannot be waived); In re EWC, 138 B.R. at 279 (other than narrow exceptions set forth in the Code, the statute does not contain provisions permitting the waiver of conflicts, as might otherwise be available outside of bankruptcy).

In In re Pillowtex, Inc., 304 F.3d 246 (3rd Cir. 2002), the bankruptcy court approved the retention of Jones Day as debtor's counsel, even though Jones Day had received certain payments during the preference period -- which payments may have been avoidable -- on condition that Jones Day would waive its rights to those funds at any subsequent time that the payments might be adjudicated as preferences. After the district court affirmed, the Third Circuit reversed, stating:

Jones Day's undertaking to waive the claims resulting from the preference [does not] resolve the issue of its possible disqualification if the fee payment was an avoidable preference.

* * *

Although a bankruptcy court enjoys considerable discretion in evaluating whether professionals suffer from conflicts, that discretion is not limitless. A bankruptcy court does not enjoy the discretion to bypass the requirements of the Bankruptcy Code.

Id. at 253-54. As such, while rules of legal ethics and professional responsibility may provide an additional frame of reference, they are not dispositive.

A growing number of cases reject the distinction between actual and potential conflicts as being determinative. Courts balance all relevant facts in ascertaining whether the connections, actual or potential, rise to the level of a disabling adverse interest. In Leslie Fay, supra, Judge Brozman summarized the analysis as follows:

Potential conflicts, no less than actual ones, can provide motives for attorneys to act in ways contrary to the best interests of their clients. Rather than worry about the potential/actual dichotomy, it is more productive to ask whether a professional has "either a meaningful incentive to act contrary to the best interests of the estate and its sundry creditors — an incentive sufficient to place those parties at more than acceptable risk — or the reasonable perception of one." In re Martin, 817 F.2d at 180-81. In other words, if it is plausible that the representation of another interest may cause the debtor's attorneys to act any differently than they would without that other representation, then they have a conflict and an interest adverse to the estate.

175 B.R. at 533 (emphasis added). Many courts adopt a definition of "adverse interest," which originally appeared in In re Roberts, 46 B.R. 815 (Bankr. D. Utah 1987), aff'd in part, modified in part and rev'd in part on other grounds, 75 B.R. 402 (D. Utah 1987). The Roberts definition provides that adverse parties must either:

(1) ... possess or assert mutually exclusive claims to the same economic interest, thus creating either an actual or potential dispute between the rival claimants as to which, if any, of them the disputed right or title to the interest in question attaches under

valid and applicable law; or (2) ... possess a predisposition or interest under circumstances that render such a bias in favor of or against one of the entities.

Id. at 826-27. See also In re AroChem Corp., 176 F.3d at 623 (slightly varying the definition, as follows: “(1) to possess or assert any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant; or (2) to possess a predisposition under circumstances that render such a bias against the estate”); In re Crivello, 134 F.3d at 835 (same as In re AroChem Corp.); In re Harold & Williams Dev. Co., 977 F.2d 906, 909-10 (4th Cir. 1992) (“court . . . must not abdicate the equitable discretion granted it by establishing rules of broad application which fail to take into account the facts of a particular case and the overall objectives of the bankruptcy system”); In re BH&P, Inc., 949 F.2d at 1315 (courts prefer reviewing facts of each case, taking into account all circumstances, rather than blindly following bright line rules); In re Martin, 817 F.2d at 182 (finding of “material adversity” requiring “prophylactic action” must be reversed, since the finding was based upon application of a per se rule); In re Gelsinger, 2000 WL 136812 at *2 (E.D. Pa. 2000) (same as In re AroChem Corp.); Beal Bank, S.S.B. v. Waters Edge Ltd. P’ship, 248 B.R. at 665 (substantially the same as In re Roberts); In re Premier Farms, L.C., 305 B.R. at 720 (substantially the same as In re Roberts); In re Enron Corp., 2002 WL 32034346 at *8 (same as In re AroChem Corp.); In re Mercury, 280 B.R. at 54 (substantially the same as In re Roberts); In re Caldor, Inc. - NY, 193 B.R. at 171; (substantially the same as In re Roberts); In re Kliegl Bros. Universal Elec. Stage Lighting Co., 189 B.R. 874, 879 (Bankr. E.D.N.Y. 1995) (substantially the same as In re Roberts); In re CF Holding, 164 B.R. at 806; In re American Printers & Lithographers, Inc., 148 B.R. at 866 (counsel had long-standing relationship with debtor’s secured lender, who also was providing debtor-in-possession financing; though counsel did not represent lender with respect to debtor’s case, representation of lender accounted for

approximately 10% of firm's total gross annual revenue and, while no claims or causes of action were anticipated by the debtor against lender, counsel disclosed that it could not sue lender if any claims were to be asserted; held, both actual and potential conflicts with respect to counsel's duty to negotiate on behalf of debtor, with significant client of the firm, and possibility of future litigation, required denial of application).^{10/}

This balancing approach has the advantage of allowing: (i) courts to retain and exercise their discretion in matters concerning the retention and compensation of professionals and (ii) clients to select, within reasonable limits, the counsel of their choice.^{11/} In addition, this approach is more in accord with the line of cases emphasizing that the appearance of a conflict can be as troublesome as an actual conflict. See, e.g., In re Crivello, 134 F.3d at 835; In re Federated Dep't Stores, Inc., 44 F.3d at 1319; In re BH&P, Inc., 949 F.2d at 1310.

Many courts which follow this balancing approach refer to or rely upon the decision in In re Leslie Fay, 175 B.R. at 525. As such, a brief review of the facts in Leslie Fay is useful. The conflict issues arose late in that case as a result of the failure of the debtors' counsel, Weil Gotshal, to have disclosed certain of its connections with parties in interest which were actual and potential litigation targets. These connections included that Weil Gotshal was counsel:

¹⁰ Such an approach seems consistent with the Restatement (Third) of the Law Governing Lawyers §201, which defines a conflict of interest as:

a substantial risk that the lawyer's representation of the client would be materially and adversely affected by the lawyers own interests or duties to others which are logically relevant to whether the lawyer's proposed retention will be affected.

Restatement (Third) of the Law Governing Lawyers §201 (1996).

¹¹ In re O.P.M., 16 B.R. at 941 (trustee is entitled to engage counsel of his own choice, subject to court approval).

- a) to certain members of the Leslie Fay Audit Committee, which members were defendants in pending securities fraud actions;
- b) to a director of both Leslie Fay and Bear Stearns, both of which were litigation targets in connection with, among other things, Bear Stearns' role as lead underwriter of a secondary offering for Leslie Fay; Bear Stearns was "a valuable" client of Weil Gotshal, whom Weil Gotshal would not sue on behalf of the debtor;
- c) to a director of Leslie Fay, both as an individual and as a general partner of another "long standing" client of Weil Gotshal;
- d) to BDO Seidman, Leslie Fay's independent auditor and a litigation target; and
- e) to the seventh largest creditor of Leslie Fay.

In response to the concern that each of the foregoing connections were with known litigation targets, raising the possibility of a fatal disabling conflict, Weil Gotshal argued that, while it would not have been disinterested had there been viable claims against these entities or had these potential targets been "significant" clients of the firm, such was not the case. In re Leslie Fay, 75 B.R. at 534-35. Judge Brozman rejected this approach and held that counsel's connections with potential litigation targets rendered it not disinterested:

I also find that Weil Gotshal was not disinterested relative to Seidman. Seidman was Leslie Fay's independent auditor throughout the period of the irregularities, and was therefore a very obvious target of potential plaintiffs. . . . Rather, it defends its disinterestedness by pointing to the relative insignificance of Seidman as a client to Weil Gotshal. . . . The short answer to this is that Weil Gotshal should be presumed to be loyal to its client. That the client may not be a major client is no reason to think that Weil Gotshal would ignore the relationship.

* * *

[A] Weil Gotshal partner, admitted in a deposition conducted by the examiner that Weil Gotshal would not have sued Seidman even if the facts warranted it. . . . , because Weil Gotshal represented accountants and "as a matter of Weil Gotshal policy," would

therefore “not sue an accounting firm period”.... Although Weil Gotshal told the Audit Committee about its policy, it elected not to impart this important information to either myself or the U.S. Trustee, an omission that is simply inexcusable. There are two problems with Weil Gotshal’s non-disclosure. Certainly that information was relevant to whether Weil Gotshal’s retention was in the best interest of the estate given that it would not sue Seidman and retention of special counsel might have entailed additional cost to the estate. But in addition, this undisclosed condition of employment particularly when coupled with a client relationship with Seidman cast doubt on whether Weil Gotshal was the proper independent counsel to conduct the investigation into Seidman’s conduct and possible liability. An unbiased investigation of the facts is no less crucial than an unbiased evaluation of the law in assessing potential claims. By unilaterally reserving the role of investigating Seidman to itself, Weil Gotshal created the “opportunity for the exercise of [its] conflicting interest,” by projecting the facts in a light more favorable to Seidman than it should have I do not say that Weil Gotshal actually did that, nor do I mean to disparage Weil Gotshal’s integrity by suggesting that it probably would have. But when evaluating conflicts of interest, I must do so objectively, “irrespective of the integrity of the person under consideration.”

Id. at 535-36 (citations omitted) (emphasis added).

Similarly, in In re Angelika Films 57th, Inc., 227 B.R. at 38, the court rejected as artificial the distinction between actual and potential conflicts. However, in Angelika Films, the court found that, notwithstanding the approval of retention after disclosure by debtor’s counsel of its representation of one of the principals of the debtor, counsel’s conduct throughout the case evidenced an actual conflict whereby the interests of the debtor’s principal were placed above those of the debtor. Id. at 40. The particularly offensive conduct was counsel’s attempt to obtain approval for the debtor to assume and assign a lease to the debtor’s principal at an amount substantially below the value of the property. The court stated:

the instant case involves circumstances in which the interests of the Debtor and of the principal clearly diverged yet counsel chose to promote the interests of the principal to the detriment of the Debtor -- a choice that Tenzer apparently made at the commencement of its representation of the Debtor.

Id. at 40.

In In re Granite Partners, supra, the court concluded that “Willkie Farr represented adverse interests, and had a meaningful incentive, or the perception of one, to act contrary to the interests of the estates.” 219 B.R. at 36. This conclusion was based principally upon connections with two significant litigation targets. First, at the outset of the case, Willkie Farr disclosed to the trustee, Harrison Goldin, that Willkie Farr’s representation of the AICPA precluded it from commencing any litigation against Price Waterhouse, but that it did not preclude WF&G from assisting Mr. Goldin in connection with his investigation of potential claims against Price Waterhouse. Second, at the inception of its retention, Willkie Farr represented Merrill Lynch, another potential litigation target. Willkie Farr failed to advise Mr. Goldin that it did not obtain a waiver from Merrill Lynch to investigate and pursue claims against Merrill^{12/} or that, during the course of the Granite case, Merrill Lynch had become a significant client of WF&G. In re Granite Partners, 219 B.R. at 36-40. The conflict, or appearance of a conflict, arising from these connections, was exacerbated by the failure to have made the requisite disclosures. In re Granite Partners, 219 B.R. at 42. Neither Mr. Goldin nor Willkie Farr advised the court of the Price Waterhouse limitation and Willkie Farr intentionally failed to advise Mr. Goldin and the court of the Merrill Lynch connections. Id.

The Court concluded:

This does not mean that Willkie Farr failed to discharge its investigative duties properly or breached its fiduciary duties to the estate. In this regard, the trustee’s report identified substantial estate claims against Merrill Lynch. But, like Caesar’s wife, trustee’s counsel must be above suspicion. Bankruptcy is concerned as much with appearances as with reality. In re Ira

¹² As noted above, such a waiver, in any event, would not eliminate the conflict issue in the Bankruptcy Court. See, e.g., In re Granite Partners, 219 B.R. at 38.

Haupt & Co., 361 F.2d 164, 168 (2d Cir. 1966) (“The conduct of bankruptcy proceedings not only should be right but must seem right”) (Friendly, J.). No matter how thoroughly or fairly Willkie Farr conducted the investigation, the question will always linger whether it held back, or failed to bite the hand that feeds it quite as hard as the circumstances warranted....

* * *

The Court concludes that Willkie Farr is not entitled to the \$2,093,700.45 in fees for investigative services, based upon the totality of conflicts and disclosure failures pertaining to Merrill Lynch, Price Waterhouse and the AICPA. Although there is no evidence that Willkie Farr failed to discharge its duties in a thoroughly professional manner, such proof need not be offered. The estate and the other objectors are not required to prove that Willkie Farr’s conflicts skewed the investigation or its results for at least two reasons. First, parties in interest, particularly clients, should not be forced to prove that a conflicted lawyer exercised his professional judgment partially and contrary to the estate’s interests. Second, the estate could prove this only by redoing the investigation...

Moreover, the investigation and final report are tainted. This taint prejudices the estates and compromises the integrity of the bankruptcy system. A trustee hiring an attorney to conduct an investigation with an eye toward identifying estate claims has the right to expect that the attorney will give him undivided loyalty and conduct an impartial investigation. The case law discussed *supra* makes clear that perception problems prevent the attorney from properly conducting an investigation into the potential wrongdoing involving important clients, close business associates or personal friends. Here, the public will always reasonably question whether Willkie Farr did something or failed to do something because of its connections with Merrill Lynch, Price Waterhouse and the AICPA.

Id. at 38-42.

The absence of a precise definition or standard of disinterestedness can lead to strange results, as evidenced by the decision of Judge Brozman in In re Vebeliunas, 231 B.R. 181 (Bankr. S.D.N.Y. 1999), appeal dismissed, 246 B.R. 172 (S.D.N.Y. 2000). After converting the case to Chapter 7, for cause, to permit, among other things, a trustee to investigate the affairs of

the individual debtor, the court, sua sponte, disqualified counsel for the trustee on the grounds of disinterestedness. Id. at 185. Oddly enough, the basis for the finding was not any economic interest or prior or current representation of any party in interest, but a “bias” which counsel expressed against the credibility of the debtor. Id. at 187. Notwithstanding that counsel’s skepticism of the debtor’s statements was based upon the fact that the debtor was a convicted felon and had previously sworn to conflicting statements, the court held:

The bottom line concern is that counsel’s independent judgment should not be compromised in any way. If the goal is disinterestedness, whether an attorney holds a bias or instead suffers from the likelihood of tainted judgment as a result of a conflict of interest, the wrong is the same, for his or her ability to maintain independence of judgment will be negatively affected.

Id. at 193.

The court did not cite any case law to support its subjective determination of “bias” of counsel as a basis for disqualification. Nor was there any support for the court’s conclusion that the skepticism of counsel impugned his ability (and the ability of his entire law firm) to investigate the affairs of the debtor and to present evidence for the court, as an impartial arbiter, to rule upon. In short, this is a troublesome decision in an already murky area of the law, which raises more questions than it answers about how we are expected to play our roles as advocates.

D. Sanctions for Violations of the Bankruptcy Code And Rules:

i) Disclosure Violations:

As noted above, the bankruptcy process must not only be right, it must seem right. In re Granite Partners, 219 B.R. at 38, quoting In re Ira Haupt, 361 F.2d at 168. Full disclosure is the key to both integrity in fact and perception. So important is this step that, regardless of the approach taken by a particular court in analyzing whether the facts require a finding of a lack of disinterestedness or an adverse interest, there is universal acceptance of the proposition that

failure to meet the disclosure requirements – even absent the existence of a conflict or any harm to the estate – is an independent basis for disqualification of a professional, denial of further compensation, or even disgorgement of legal fees paid. See, e.g., In re Big Rivers Elec. Corp., 355 F.3d 415, 437 (6th Cir. 2004) (disgorgement of all fees of examiner and his law firm); In re Crivello, 134 F.3d at 839; Rome v. Braunstein, 19 F.3d at 59 (disqualification and denial of fees); In re Consolidated Bancshares, Inc., 785 F.2d 1249, 1256 n.7 (5th Cir. 1986); In re Futronics, 655 F.2d at 471; In re El San Juan Hotel Corp., 239 B.R. at 649-51 (disqualification and denial of fees); In re Tomczak, 283 B.R. 730, 736 (Bankr. E.D. Wis. 2002) (disqualification and denial of all post petition fees); In re Granite Partners, 219 B.R. at 40; In re 245 Assocs., LLC, 188 B.R. at 750; In re Leslie Fay, 175 B.R. at 533; In re EWC, 138 B.R. at 280; In re Maui 14K, Ltd., 133 B.R. 657, 660-61 (Bankr. D. Haw. 1991); In re Diamond Lumber, Inc., 88 B.R. 773, 777 (N.D. Tex. 1988) ; In re Marine Power & Equip. Co., 67 B.R. 643, 648 (Bankr. W.D. Wash. 1986). Indeed, in In re Hot Tin Roof, 205 B.R. at 1003, the court noted:

Where the professional maintains any connections proscribed by §327(a) and does not disclose those connections, the attorney should expect nothing more than the denial of compensation requested and disgorgement of fees received.

Notwithstanding decisions which hold that any failure to make complete disclosure requires disqualification, denial of compensation and disgorgement (see, e.g., In re EWC, 138 B.R. at 280-84), it appears that the trend is for the court to retain its discretion in fixing an appropriate sanction and consider all relevant facts. For example, the court will consider whether the failure to disclose was willful, negligent or inadvertent; whether the non-disclosure was material and whether any harm was caused to the estate. In re Crivello, 134 F.3d at 839 (“it is not our role to reduce the discretion the Code affords bankruptcy courts by carving out an exception that requires the denial of fees if a professional willfully fails to disclose”); In re

BH&P, 949 F.2d at 1316-17; In re Leslie Fay, 175 B.R. at 538-39. Indeed, in In re Granite Partners, 219 B.R. at 40-41, the court noted:

Attorneys who seek appointment owe a duty of full disclosure... [and] ... [i]f that duty is neglected, however innocently, surely they should stand no better than if it had been performed.... At a minimum, failure to disclose is an exacerbating factor warranting the denial of fees for lack of disinterestedness.

Nevertheless, the court in Granite considered all of the facts before disallowing all fees relating to investigative services, which were “tainted,” and disallowing a portion of WF&G’s fees relating to its general bankruptcy work, on the ground that the taint spilled over into the bankruptcy -- non investigative services -- and caused the estate additional expense. 219 B.R. at 42-43. However, the court refused to disallow all fees relating to these services, finding that Willkie Farr, in fact, had provided exceptional services which were valuable to the estate. Id. at 43.

Similarly, in In re El San Juan Hotel Corp., 239 B.R. at 648-51, after acknowledging that in the First Circuit there is no “bright line rule requiring denial of all compensation because of a conflict,” the court denied all compensation to counsel for a successor trustee based upon the particular facts of the case, where, in addition to not disclosing that such counsel represented the original trustee in a prior unrelated bankruptcy, such counsel also urged the successor trustee not to pursue an action against the original trustee.

ii) **Disinterestedness and Adverse Interest Violations:**

Even after a determination that a professional previously retained is either not disinterested or holds an interest adverse to the estate, there is no uniform rule about the severity of the sanction to be imposed. Certain courts adopt a per se rule which, in effect, maintains that for a valid retention, a professional must, at all times, be both disinterested and without any adverse interest. Accordingly, if it is subsequently determined that the professional, at any time,

failed to satisfy both tests, the retention must be voided and all fees disgorged. See, e.g., In re Federated, 44 F.3d at 1318-20. In Federated, the debtor sought to retain Lehman Brothers as its financial advisor. Lehman disclosed all connections with the debtor, including its (i) holding substantial amounts of the debtor's debt and preferred equity; (ii) serving as the debtor's lead underwriter; and (iii) serving as the debtor's investment advisor in connection with an ill-fated LBO. Id. at 1313. The bankruptcy court approved the retention of Lehman over the objection of the United States Trustee. The United States Trustee appealed to the district court; and while the appeal was pending, the Sixth Circuit rendered its decision in In re Middleton Arms Ltd. P'ship, 934 F.2d 723, 725 (6th Cir. 1991), which held that a bankruptcy court could not use its equitable powers or discretion to approve a professional who was not disinterested. When the Federated case reached the Sixth Circuit, it applied its holding in Middleton Arms, and required Lehman to disgorge all fees allowed and paid subsequent to the Middleton Arms decision, stating:

the plain language of §328(c) limits the bankruptcy court's discretion to grant or deny compensation to a professional person employed under §327 Since Lehman Brothers was an interested person from the outset, it was never a professional person employed under that section

* * *

Accordingly, we hold that a valid appointment under §327(a) is a condition precedent to the decision to grant or deny compensation under §330(a) or §328(c).

44 F.3d at 1320 (internal quotation marks omitted).

Similarly, in a more recent decision of the same court, In re Big Rivers Elec. Corp., 355 F.3d 415 (6th Cir. 2004), an examiner, J. Baxter Schilling, and his law firm, the Law Firm of J. Baxter Schilling, were required to disgorge all fees paid to them, aggregating almost \$1 million, after the examiner was found to lack disinterestedness. Id. at 422. The examiner negotiated a success fee from three of the debtor's creditors, each of whom agreed that the examiner would

receive a percentage of any increased recovery that he collected on their behalf, over and above the examiner's hourly fee. Id. at 421. Schilling did not disclose this fee arrangement. Id. The Court enumerated a number of potential biases that an examiner in these circumstances might have, including that he might decline to investigate causes of action against his creditor patrons. Id. at 434. See also In re Granite Sheet Metal Works, Inc., 159 B.R. 840, 848-49 (Bankr. S.D. Ill. 1993) (post-petition representation reflected a primary allegiance to the debtor's controlling shareholder, rather than to the debtor, coupled with an absence of full disclosure; held, fees must be denied and, to the extent paid, disgorged).

Once again, however, the majority of decisions, the trend, and arguably the better approach appears to be to reject per se rules in favor of the sound exercise of discretion based upon all of the facts. See, e.g., In re Crivello, 134 F.3d at 837-38; Rome v. Braunstein, 19 F.3d at 62-63 (counsel for Chapter 11 debtor simultaneously represented (i) debtor's principal shareholder in chapter 7 proceeding and (ii) an employee of the debtor in connection with her efforts to purchase property from the debtor's estate; court rejected a per se or bright line rule but denied in toto counsel's application for fees (approximately \$143,000) for both cases and affirmed retroactive revocation of counsel's retention); In re BH&P, Inc., supra, (affirming disqualification of counsel from representing individual chapter 7 debtors, who were principals of corporate chapter 7 debtor represented by same counsel, where corporate debtor asserted claims against individual debtors, based upon consideration of several factors, including nature of disclosure of conflict and nature of inter-debtor claims); In re Martin, 817 F.2d 175 (1st Cir. 1987) (rejecting per se disallowance of fee arrangement whereby clients gave mortgage and note pre-petition to secure payment of bankruptcy fees); In re Futuronics, 655 F.2d 463 (2d Cir. 1981) (bankruptcy court abused its discretion in awarding fees to special and general counsel to the

debtor on the ground that counsel engaged in fee splitting arrangement and intentionally and flagrantly breached fiduciary duty to disclose this arrangement to the court); In re Hot Tin Roof Inc., 205 B.R. at 1001, 1004 (disgorgement of fees ordered where applicant failed to disclose his multiple representations of three related debtors with divergent interests); In re United Merchants and Mfrs., 1999 WL 4929 (S.D.N.Y. 1999) (notwithstanding extensive conflicts checks, counsel for debtor failed to find that one of its partners held an equity interest in debtor, and thus failed to promptly disclose his stock ownership; district court affirmed the bankruptcy court's holding that counsel was not disinterested by virtue of the equity interest, even though such interest was of no economic value and did not create an interest adverse to the estate; the court imposed an economic sanction tied to portion of compensation earned prior to disclosure to emphasize the importance of disclosure to the integrity of the system and the need for vigilant enforcement), aff'd, 198 F.3d 235 (2d Cir. 1999); In re Wheatfield, 286 B.R. at 421 (“[a] potential conflict of interest may also require the disqualification of a professional if, in the judgment of the court, the conflict is sufficiently important and there is a sufficient likelihood that it will ripen into an actual conflict”); In re Enron Corp., 2002 WL 32034346 at *10 - *11 (creditor asserted that committee counsel, Milbank Tweed, had interests adverse to the estate because, among other reasons, (i) Milbank received presumptively preferential payments in the amount of \$449,948.97 and (ii) it had represented the debtors pre-petition; held, not a basis for disqualification because Milbank waived its right to litigate the preference issue, and conflicts counsel and an examiner would each monitor Milbank's actions in the bankruptcy case); In re Midway Indus. Contractors, Inc., 272 B.R. at 665 (chapter 11 debtor's counsel failed to disclose that he was a pre-petition, secured creditor of the estate; held “[i]n light of this prejudice, the exceedingly long time it took for a disclosure to finally be made, and in consideration of the need to ensure compliance by

professionals with the Bankruptcy Code and Rules, the Court agrees with the United States trustee that it is appropriate to limit the fee allowance to an amount equal to the retainer” – a 44% fee reduction); In re Angelika Films 57th, Inc., 227 B.R. at 43-45 (court is given broad discretion to assess the facts before determining whether to deny all or part of fees for the period before and after failure to comply with §327; notwithstanding disclosure of possible conflict, court denied in toto fees and expenses requested from inception of the case where court found that counsel either had an actual conflict from the inception of the case, or a conflict which arose during the case and which rendered counsel incapable of providing any benefit to the estate); In re Granite Partners, 219 B.R. at 440-41 (the bankruptcy court has substantial discretion under Code §328(c) to deny or reduce fees based upon, inter alia, lack of disinterestedness); In re Benjamin’s Arnolds, 1997 WL 86463 at *7 (“the bankruptcy court has discretion to deny compensation and reimbursement to a conflicted professional”); In re 245 Assocs., LLC, 188 B.R. at 750 (application which included boilerplate statement of disinterestedness, failing to disclose any specific connections with the estate, creditors or the debtor’s professionals, could not support retention since Rule 2014 must be strictly followed and failure to do so provides basis to disallow fees or disqualify professional); In re Leslie Fay, 175 B.R. at 530-31 (examiner concluded that Weil Gotshal (i) was not disinterested, (ii) failed to make the necessary disclosures but (iii) did not cause any harm to the debtor and represented the debtor in an exemplary manner; nevertheless, the court found that the non-disclosures caused Leslie Fay “very real harm,” both in the time and cost of the review of Weil Gotshal’s conduct, and by calling into question the “integrity of the judicial process by which disinterested counsel is selected” and imposed economic sanctions limited to the direct and indirect costs incurred by the estate by virtue of the non-disclosures); In re CF Holdings, 164 B.R. at 799 (debtor’s investment

advisor failed to timely disclose that during his employment he invested \$2 million in an entity whose controlling principal was seeking to purchase a majority interest in the debtor, and debtor's counsel failed to disclose the investment after acquiring actual knowledge of such investment; held, in the exercise of court's discretion, and based upon Code §328(c), investment advisor's compensation would be reduced substantially without regard to contention that conflicting economic investment was de minimis or that investment advisor performed in the best interests of the debtor; counsel's considered refusal to have brought this information before the court was sufficient basis to reduce compensation); In re Begun, 162 B.R. 168 (Bankr. N.D. Ill. 1993) (boilerplate denials of connections with the debtor failed to reveal that (i) one of the partners of the debtor's counsel owned an equity stake in the broker's business; (ii) another partner of the law firm was the brother of a vice president of the broker; and (iii) the law firm represented the broker in various matters; held, \$75,000 of \$150,000 commission denied).

CONCLUSION

The ethical issues that confront a professional prior to accepting the representation of a debtor or an official committee can be significant and hazardous if mishandled. Not only will the professional be required to ensure that his or her firm is "disinterested" under the Bankruptcy Code, but also that, independent of that analysis, there is no risk of violating existing state ethics codes regarding conflicts of interests with both present and former clients.

These inquiries must be made with care and thoroughness and must continue to be made throughout the course of the bankruptcy proceeding. A later arising conflict which is not promptly and properly identified and disclosed can be just as disqualifying as a conflict that existed at the outset of the representation. Failure to make full and timely disclosure of present and former representations of other clients whose interests may be affected by the bankruptcy

representation could give rise to disqualification and sanctions, including disallowance and disgorgement of fees.

In both large and small cases alike, bankruptcy professionals are given very little margin for error. Accordingly, the first step in the process of representation of a client, i.e. deciding whether to accept or reject the proposed representation, has taken on particular importance.

In sum, professionals who must seek bankruptcy court approval for their retention and fees must carefully seek out all connections with the debtor, its creditors and parties in interest; and regardless of the magnitude of such connections, disclose, disclose and disclose again! Professionals who fail to proceed in this manner, proceed at their own peril. Indeed, under such circumstances, disallowance of fees may be the least of their problems. See, e.g., U.S. v. Gellene, 182 F.3d 578 (7th Cir. 1999) (criminal sanctions upheld under 18 U.S.C. §§152 and 1623 regarding false and fraudulent declarations in connection with retention and fee applications).