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LITIGATION: ETHICAL ISSUES IN RETENTION OF PROFESSIONALS

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I. Roles and Fiduciary Duties of Professionals to be Paid by the Bankruptcy Estate While Representing Different Parties in Interest, Including Debtor-in-Possession, Official Committees, Trustee, Examiner, Secured Creditor, and Party Asserting "Substantial Contribution" Claim Under § 503(b)(3)(D)

- A "professional" in the bankruptcy context includes attorneys, accountants, appraisers, auctioneers, or other professional persons. The term "other professional persons" has been judicially construed to include those who play a central role in the administration of the bankruptcy estate. Professionals are required to seek formal retention by court order.
- All attorneys are bound by the ethical codes or rules applicable in the jurisdiction where they practice. Additionally, bankruptcy law often sets a higher standard for the application of ethical concepts.
- The Sarbanes-Oxley Act of 2002 also places strict rules on attorneys who represent public companies. Congress required the SEC to issue new standards "for attorneys appearing and practicing before [the SEC] in any way in the representation of issuers" of publicly traded securities. 15 U.S.C. § 78(m). The SEC has responded by issuing standards of professional conduct published at 17 C.F.R. Part 205. There is no reported authority on the application of these rules in the Chapter 11 context.
- The Supreme Court has held that trustees have duties to all parties in interest in a bankruptcy and must act as fiduciaries in connection therewith. *Wolf v. Weinstein*, 372 U.S. 633, 642 (1963); *Commodity Futures Trading Comm'n v. Weintraub*, 471

U.S. 343, 355-56 (1985). The debtor in possession is also a fiduciary for the estate and its beneficiaries. *In re United Healthcare Sys., Inc.*, 200 F.3d 170 (3d Cir. 1999).

- An attorney or accountant for the official committee may not represent any other entity having an adverse interest in connection with the case; however, representation by committee counsel of one or more creditors of the same class as represented by the committee does not necessarily constitute representation of an adverse interest. 11 U.S.C. § 1103(b).
- A professional's "previous or concurrent employment by or representation of a creditor is not, by itself, a bar to employment by the trustee absent an *actual* conflict of interest." 5 L. King, *et al.*, *Collier on Bankruptcy*, ¶ 327.04 (15th ed. 1979). The nature and scope of the representation; the time period in relation to the bankruptcy and the creditor's position in the case are relevant factors.
- An examiner owes the same fiduciary duties to the estate as the trustee. *In re Big Rivers Elec. Corp.*, 355 F.3d 415, 431 (6th Cir. 2004).
- Section 503(b)(3) permits "a creditor, an indenture trustee, an equity security holder, or committee representing creditors or equity security holders other than a committee appointed under section 1102 of this title" to seek reimbursement for professional services "in making a substantial contribution in a case under chapter 9 or 11 of this title", nothwithstanding the fact that the professional has not had any fiduciary duty to the estate. Case law, and not the statute, defines "substantial contribution"; the term has generally been defined narrowly by the courts.

II. Disinterestedness Requirement under § 327

- A trustee may employ only attorneys, accountants, appraisers and other professional persons not holding or representing an interest adverse to the estate. In addition, a trustee may employ only professional persons who are "disinterested" persons. 11 U.S.C. § 327(a).
- "Disinterested person" is defined in § 101(14); a disinterested person:

    1. is not a creditor, an equity security holder, or an insider;

    2. is not and was not, within two years before the date of filing of the petition, a director, officer, or employee of the debtor; ... and

    3. does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor.

- Courts disagree as to how the various tests of disinterestedness should be applied. The majority demands strict, *per se* application of the statute. *In re Pierce*, 809 F.2d 1356, 1362 (8th Cir. 1987); *In re Middleton Arms, L.P.*, 934 F2d 723, 725 (6th Cir. 1991); *In re Harold & Williams, Dev. Co.*, 977 F.2d 906, 909 (4th Cir. 1992). The First Circuit has held that there is no *per se* rule mandating disqualification of a professional who fails the "disinterested" test. *In re Martin*, 817 F.2d 175 (1st Cir.

1987) (setting forth a non-exclusive list of ten factors in determining whether a relationship with the debtor renders a professional disinterested).

III. Disqualification – Factors Bearing on Determination of Disinterestedness and Existence of "Actual" Conflict of Interest

- "Adverse interest" is not defined in the Bankruptcy Code.
- One recent case defines "adverse interest" as:
    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 WorldCom, Inc., 311 B.R. 151, 163-64 (Bankr. S.D.N.Y. 2004).
- The decision whether an adverse interest exists is determined by the court on a case-by-case basis. *Id.*

- Section 101(14) defines "disinterested person as set forth above; there are in effect five tests which, if satisfied, deems a person disinterested. The tests provide that a person is a disinterested if he:
    1. is not a creditor, an equity security holder, or an insider;
    2. is not and was not an investment banker of the debtor for any outstanding security of the debtor;
    3. 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…;

4. 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; and
5. does not have an interest materially adverse to the interest of the estate.

- The materially adverse interest standard incorporated into the definition of disinterestedness under § 101(14)(E) and the "interest adverse to the estate" language in § 327(a) overlap and are duplicative.

IV. Problems Arising From Unpaid Pre-Petition Bills or Receipt of Potential Preferences, and Options for Addressing Such Problems

a. <u>If counsel is a creditor of the debtor for attorneys' fees:</u>

- *In re Martin*, 817 F.2d 175 (1st Cir. 1987). Rejecting a *per se* standard of disqualification for professionals holding prepetition claim for services, where those services were related to the bankruptcy filing.

- *United States v. Price Waterhouse*, 19 F.3d 138 (3d Cir. 1994). Reading § 101(14) literally and thus rejecting employment of debtor's prepetition accountants who held a substantial claim against the estate.

- *In re LKM Indus., Inc.*, 252 B.R. 589 (Bankr. D. Mass. 2000). Holding that where there is a debt for prepetition services not rendered in conjunction with the filing of the chapter 11 the *Martin* standard is inapplicable and the professional is disqualified *per se*.

- However, under § 327(e), the trustee may employ for a special purpose an attorney who has previously represented the debtor, provided the attorney does not hold an adverse interest. (Note that this provision does not cover accountants. *U.S. v.*

Price Waterhouse, 19 F.3d 138, 141-42 (3d Cir. 1994); *In re Andover Togs*, 2001 WL 262605, *4-5 (S.D.N.Y. 2001).)

b. If counsel is a recipient of a voidable transfer:

- *In re First Jersey Securities, Inc.*, 180 F.3d 504 (3d Cir. 1999). Receipt of a preference constitutes a conflict of interest requiring disqualification.

c. If counsel is a recipient of a transfer that might be a voidable preference:

- *In re Pillowtex, Inc.*, 304 F.3d 246 (3d Cir. 2002). Reversing decision below that authorized employment of DIP counsel over objection of U.S. Trustee who contended that payment of counsel's fees by the debtor within 90 days prior to bankruptcy might constitute an avoidable preference and thus create a conflict of interest.

- *In re Enron Corp.*, No. 01-16034, 2002 WL 32034346 (Bankr. S.D.N.Y. 2002). Finding that counsel's "agreement to waive any right to challenge the Examiner's determination concerning any preference and claim thereto has the same effect as a professional waiver of a claim in order to satisfy the disinterested standard of § 101(14)(A) – an accepted practice that has been employed in this case, and many other cases."

V. Retention of Turnaround Consultants Under § 363(b) versus § 327(a)

- Section 327(a) permits the debtor and the committee to retain professionals with the court's approval. Professionals employed under § 327(a) must be disinterested under the § 101(14) standards. See *In re Capitol Metals Co., Inc.*, 228 B.R. 724

(B.A.P. 9th Cir. 1998) (individual and firm who acted as CFO of the debtor prepetition disqualified from employment under § 327(a)).

- *In re Metropolitan Hospital*, 119 B.R. 910, 915 (Bankr. E.D. Pa. 1990), held that in order to be employed under § 327(a), the person must be a "professional" and also must "represent, or assist, the trustee in the fulfillment of [the debtor in possession's] official duties." A professional for purposes of this section is a person who has "special knowledge and skill usually achieved by study and educational attainments whether licensed or not." *Id*. at 916.
- Courts have applied quantitative and qualitative tests, as well as a combination of the two tests, to determine whether the person is a "professional person" for purposes of § 327(a). The quantitative test examines whether the person plays a central role in administration of the debtor's bankruptcy case, as opposed to the day-to-day operations of the debtor. *In re First Merchant's Acceptance Corp.*, 1997 WL 873551, *2 (D. Del. 1997). The qualitative test considers a number of factors, no one of which is determinative, related to the role that the proposed "professional person" plays in assisting the debtor. *Id.* Such factors include the level of control exercised, the autonomy given to the entity, the degree of special knowledge or skill that the entity has, and the extent of the entity's involvement in the administration of the debtor's estate. *Id.* at *3.
- Section 363(b), read in conjunction with § 363(c), permits the debtor in possession to employ certain professional and nonprofessional persons in the ordinary course of business without court approval.

- Whether an employment is in the ordinary course of business is a factual inquiry; courts apply a two-part inquiry with a vertical and a horizontal component. The **vertical test** considers the economic expectations of the creditor pre-petition. The **horizontal test** addresses whether the transaction is common practice in the industry. *In re Drexel Burnham Lambert Group Inc.*, 112 B.R. 584 (Bankr. S.D.N.Y. 1990).
- Whether the retention of a turnaround management company under § 363 is permissible is a matter of debate. Questions arise as to whether such an employment can properly satisfy the relevant tests. One perspective is that certain industries, which have suffered economically for prolonged periods, may employ such professionals so commonly that it has become an ordinary business practice within that industry. Likewise, it may be the expectation of a pre-petition creditor that if the debtor encounters economic difficulties, the debtor will take the necessary steps the right itself by hiring a turnaround expert or consultant. See e.g., *In re 4 C Solutions, Inc.*, 289 B.R. 354, 357 (Bankr. C.D. Ill. 2003).

VI. Disclosure and Role of Court in Determining Eligibility and Disqualification Issues

- Bankruptcy Rule 2014 requires full disclosure of all facts about a lawyer's "connections" to the debtor and creditors of the debtor, and to any party in interest. *In re Leslie Fay Cos., Inc.*, 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994), held that "[a]ll facts that may have any bearing on the disinterestedness of a professional must be disclosed," and emphasized that "it is the responsibility of the professional, not of the court, to make sure that all relevant connections have been brought to light." In *In re Begun*, 162 B.R. 168, 177 (Bankr. N.D. Ill. 1993), the

court interpreted Rule 2014(a) to require disclosure of any interest antagonistic to the interests of the estate.

- Professionals may not omit disclosing a connection on the basis that they believe the relationship is insignificant or irrelevant. *Smith v. Marshall (In re Hot Tin Roof, Inc.)*, 205 B.R. 1000, 1003 (B.A.P. 1st Cir. 1997); *In re Crivello*, 194 B.R. 463 (E.D. Wisc. 1996).
- Denial of fees is one possible sanction for knowing failure to disclose. *In re EWC*, 138 B.R. 276 (Bankr. W.D. Okla. 1992); *Halbert v. Yousif and Tanners, Inc.*, 225 B.R. 336 (Bankr. E.D. Mich. 1998).
- Some courts interpret sanctions as being non-discretionary, to maintain the integrity of the bankruptcy system. *In re EWC*, 138 B.R. 276 (Bankr. W.D. Okla. 1992) (stating compliance with disclosure requirements "is necessary to maintain the integrity of the bankruptcy system," and that knowing failure to disclose must result in setting aside employment, denial of compensation, and disgorgement of compensation already received).
- One court has held that a professional may be permitted compensation where the conflict arose after the original retention and there was full disclosure, but retention was reversed on appeal. *First Interstate Bank of Nevada, N.A. v. CIC Investment Corp.*, 192 B.R. 549, 533 (B.A.P. 9th Cir. 1996).
- One possible remedy to conflict issues is to retain separate counsel, in addition to the debtor's bankruptcy counsel (absent any appearance of conflict). *In re Enron Corp.*, No. 01-16034, 2002 WL 32034346 (Bankr. S.D.N.Y. 2002).

The forgoing outline draws on the following published sources, which may also be referenced for further information:

Daniel M. Lewis and Jamie L. Witten, Arnold and Porter, "Ethical Issues Concerning Conflicts and Disclosure of Conflicts for a Debtors' Counsel," Bankruptcy 2004: Views From the Bench (2004).

Michael L. Cook, "Professional Retention, Payment and Ethical Disputes," Bankruptcy Litigation Manual § 20.05.

Marcia L. Goldstein, Melissa I. Hoffman, Craig E. Johnson, "Retention of Professionals in Bankruptcy Cases: Ethical Issues and Special Considerations," Bankruptcy and Business Reorganization 2003.

Kurt F. Gwynne, "Employment of Turnaround Management Companies, 'Disinterestedness' Issues Under the Bankruptcy Code, and Issues Under Delaware General Corporation Law," American Bankruptcy Institute Law Review, Winter 2002.

5 L. King, *et al.*, *Collier on Bankruptcy* (15th ed. 1979).