When an attorney proposes to represent a debtor-in-possession (“DIP”) in a chapter 11 bankruptcy case, she must evaluate whether her law firm meets the qualifying tests imposed by the Bankruptcy Code, and also the applicable state professional responsibility code or rules, generally some form of the Model Rules of Professional Conduct. Often, the law firm will already represent other parties in interest in the case, resulting in conflicts of interest, or have other connections with the DIP or its owners or creditors. This paper discusses the applicable statutes, rules and case law, and steps that counsel should take to determine and attempt to resolve conflict and qualification issues, including through seeking consent from existing firm clients.

A. Disinterestedness and Lack of Any Adverse Interest.

Bankruptcy Code § 327(a) requires that counsel for the trustee not “hold or represent an interest adverse to the estate” and be a “disinterested person.” Courts have held that § 1107 imposes the same requirement on counsel for the DIP.2 “Disinterestedness” by definition includes a checklist of attributes for the applicant counsel, such as not being itself a creditor or equity security holder.3 It also requires that the applicant not personally hold an interest “materially adverse” to the estate or any class of creditors or equity holders.4 To that extent only it overlaps the § 327(a) requirement that the applicant not “hold” or “represent” an adverse interest.

Adverse interest has been defined broadly to mean either (i) possessing or asserting any economic interest that would tend to lessen the value of the bankruptcy estate or that would

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1 This outline is substantially adapted from Chapter 27, Ethical Responsibilities, NORTON BANKRUPTCY LAW AND PRACTICE 2D (Clark Boardman Callaghan), written by this author.
2 See In re Eagle-Picher Industries, Inc., 999 F.2d 969 (6th Cir. 1993)(§ 1107(b) exception narrow); In re Martin, 817 F.2d 175 (1st Cir. 1987); But see In re Howard Smith, Inc., 207 B.R. 236 (Bankr. W.D. Okl. 1997)(§ 1107(b) exception allows employment of creditor accountant without waiver of de minimus claim); Matter of Federated Department Stores, Inc., 20 B.C.D. 973 (Bankr. S.D. Ohio 1989) (court appointed investment banker for debtor despite failure to meet strict disinterestedness standards, holding DIP has more leeway to do so than trustee, and debtor has compelling need for professional with its qualifications; most if not all comparably qualified investment bankers have same conflicts).
4 In re Arochem Corp., 176 F.3d 610, 629 (2d Cir. 1999)(personal standard); In re BH & P, 949 F.2d 1300, 1310 (3d Cir. 1991) (same); In re Hunto, Inc., 288 B.R. 229 (Bankr. E.D. Mo. 2002) (personal standard for disinterestedness does not apply when firm merely represents materially adverse interest; evaluate representational adversity by flexible fact-specific analysis).
create either an actual or potential dispute in which the estate would be a rival claimant, or (ii) possessing or having a predisposition under the circumstances to be biased against the estate. A number of courts have also used a disinterestedness test of whether the person “in the slightest degree might have some interest or relationship that would even faintly color the independence and impartial attitude required by the Code and the Bankruptcy Rules,” but that test was rejected by the Third Circuit as a discredited “appearance of impropriety” standard.

The circuit courts tend to read the statutory requirements literally, when the disqualifying attribute is specifically set forth in the Code, such as being a creditor or insider. These cases have not dealt with facts that are difficult to justify, however, such as a law firm associate owning a few equity shares in a publicly traded debtor. When the Code does not explicitly mandate disqualification, i.e., when the issue is existence of a material adverse interest, most circuit court cases have evaluated the facts of the case from an abuse of discretion perspective, focusing on materiality of the arguably-disqualifying facts, and weighing potential difficulties against potential advantages to the estate. Counsel must present evidence of the likelihood the potential conflict might turn into an actual one, and the influence this conflict is likely to have on decision-making, i.e., the likelihood of material adversity.

Under Code § 327(e), special counsel need not be disinterested, and must lack a material adverse interest only with respect to the matter on which the attorney is to be employed. An application to employ special counsel must include sufficiently detailed

5In re Roberts, 46 B.R. 815, 826-27 (Bankr. D. Utah 1985), aff'd in part, 75 B.R. 402 (D. Utah 1987); In re Granite Partners, L.P., 219 B.R. 22 (Bankr. S.D.N.Y. 1998); see also In re Leslie Fay Companies, Inc., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994)("... if it is plausible that the representation of another interest may cause the debtor's attorneys to act differently than they would without that other representation, then they have a conflict and an interest adverse to the estate."); Roger J. Au & Sons v. Aetna Ins. Co. (In re Roger J. Au & Sons, 64 B.R. 600, 604 (N.D. Ohio 1986); In re Michigan General Corp., 78 B.R. 479 (Bankr. N.D. Tex. 1987).


7In re Prince, 40 F.3d 356 (11th Cir. 1994); U.S. Trustee v. Price Waterhouse, 19 F.3d 138 (3d Cir. 1994); In re Middleton Arms, Limited Partnership, 934 F.2d 723 (6th Cir. 1991) (court cannot use § 105 powers to disregard disinterestedness criterion); In re Pierce, 809 F.2d 1356 (8th Cir. 1987) (only Congress, not courts, can change disinterestedness requirements). In re Eagle Picher Industries, Inc., 999 F.2d 969 (6th Cir. 1993)(investment banker for outstanding securities of DIP); see also In re Park-Helena Corp., 63 F.3d 877 (9th Cir. 1995) (disclosure rules to be literally construed, even if results are harsh).

8 In re Marvel Entertainment Group, Inc., 140 F.3d 463 (3rd Cir. 1998); In re Occidental Financial Group, Inc., 40 F.3d 1059(9th Cir. 1994); In re Interwest Business Equipment, Inc., 23 F.3d 311 (10th Cir. 1994); In re Martin, 817 F.2d 175 (1st Cir. 1987); In re International Oil Co., 427 F.2d 186 (2d Cir. 1970); In re B H & P, Inc., 494 F.2d 1300 (3d Cir. 1971); In re Harold & Williams Development Co., 977 F.2d 906 (4th Cir. 1992); In re Consolidated Bancshares, Inc., 785 F.2d 1249 (5th Cir. 1986)(facts regarding alleged conflict in representing DIP and officer/director must be brought out at hearing to evaluate whether conflict exists); but see In re Freedom Solar Center, 776 F.2d 14 (1st Cir. 1985)(resolve doubts in favor if disqualification); In re W.F. Development Corp., 905 F.2d 883 (5th Cir. 1990), cert. denied 111 S.Ct. 1311 (1991)(no hearing necessary as to general partner/limited partner, since always a conflict).

disclosures to enable the court to determine whether there is such a disqualifying adverse interest. \textsuperscript{10} Attorneys cannot purport to serve as special counsel to bypass disinterestedness requirements while in fact acting as bankruptcy counsel. \textsuperscript{11} If special counsel has a conflict arising from representation of a creditor rather than prior representation of the debtor (as referenced in § 327(e)), some courts have held the attorney will be disqualified. \textsuperscript{12}

\textbf{B. Representation of Multiple, Affiliated Entities.}

Courts generally focus on the insider’s/affiliate’s status as a creditor as a key reason for disqualifying his DIP counsel as the affiliated entity’s DIP counsel. But representation of a creditor is not a disqualifying “adverse interest” unless there is “an actual conflict of interest.” \textsuperscript{13} The difference between actual and potential conflicts is discussed in the attorney ethics rules and codes, and by bankruptcy courts in the context of joint representation of affiliated DIPs.

Professional conduct rules prohibit representation of one client directly adverse to another client or materially limited by counsel’s responsibilities to another client or third person or his own interests, unless a waiver is obtained. If the lawyer reasonably believes the representation will not be adversely affected, and the clients consent after consultation, multiple representation can go forward. \textsuperscript{14} The clients who are to waive the conflict would be the related

\textsuperscript{10} In re Maximus Computers, Inc., 278 B.R. 189 (9th Cir. BAP 2002) (prepetition representation of creditor disclosed, but not postpetition representation or impact of creditor’s fee payment on special counsel’s fee applications); In re Molten Metal Technology, Inc., 289 B.R. 505 (Bankr. D. Mass. 2003) (failure to disclose joint defense agreement that restricted special counsel’s ability to disclose information useful to estate); In re Fretter, Inc., 219 B.R. 769 (Bankr. N.D. Ohio 1998) (inadequate disclosure by special counsel and adverse interests with respect to its representation sanctioned); but see In re Adam Furniture Industries, Inc., 191 B.R. 249 (Bankr. S.D. Ga. 1996) (lesser disclosures needed for special counsel).

\textsuperscript{11} In re Abrass, 250 B.R. 432 (Bankr. M.D. Fla. 2000); In re Tidewater Memorial Hospital, Inc., 110 B.R. 221 (Bankr. E.D. Va. 1989); In re Argus Group 1700, Inc., 199 B.R. 525 (Bankr. E.D. Pa. 1996) (bankruptcy case was two-party dispute so litigation counsel was primary legal advisor).


\textsuperscript{13} 11 U.S.C. § 327(e); In re BH & P Inc., 949 F.2d 1300 (3d Cir. 1991) explained in In re Marvel Entertainment Group, Inc., 140 F.3d 463 (3d Cir. 1998).

\textsuperscript{14} ABA Model Rule of Professional Conduct ("Model Rule") 1. 7. Model Rule 1.13(e) specifically authorizes counsel for an entity to represent its officers, shareholders or other constituents also, subject to the provisions of Model Rule 1.7. But see In re Amdura Corp., 121 B.R. 862, 866 (Bankr. D.Col. 1990)(while attorney professional conduct code applies to determination of disqualification, court recognizes "that activities and multiple representation that may be acceptable in commercial settings, particularly with the informed consent of clients, may not be acceptable in bankruptcy"). See In re Covenant Financial Group of America, Inc., 243 B.R. 450 (Bankr. N.D. Ala. 1999)(no inherent conflict in
DIP entities. However, the court may determine as a disinterested party that the client should not agree to the representation under the circumstances. Attorney ethics rules do not require disqualification for potential conflicts. Several bankruptcy courts, however, have concluded that all potential conflicts are actual conflicts.

A lawyer retained by an entity owes allegiance to the entity, and not its shareholders or partners. Counsel is not to be influenced by the personal desires of people related to the entity—sometimes a very difficult task. Majority stockholders, for example, are frequently not only officers and directors, but also guarantors of a closely-held corporation’s debts. Positions taken by the DIP can adversely affect a guarantor-controlling owner, while a contrary position could be less helpful to the corporation as a whole. The same problems occur with debtor partnerships, where a general partner is liable even without a guarantee.


15Model Rule 1.7 Comment. Some courts have written of the need for notice to creditors of DIP attorney conflicts in terms of creditor waiver. See In re Plaza Hotel Corp., 111 B.R. 882 (Bankr. E.D. Cal. 1990); In re Lee, 94 B.R. 172 (Bankr. C.D. Cal. 1988); In re BH & P, Inc., 103 B.R. 556 (Bankr. D.N.J. 1989), rev’d in part 949 F.2d 1300 (3d Cir. 1991). See In re Perry, 194 B.R. 875 (E.D. Cal. 1996)(creditors are real parties in interest so debtor cannot waive conflict). The court in In re B.E.S. Concrete Products, Inc., 93 B.R. 228, 235 (Bankr. E.D. Cal. 1988) held that the parties themselves could waive the conflict upon appropriate disclosures, but noted that "the waiver is more difficult to obtain in a chapter 11 case because the debtor in possession stands in a fiduciary capacity that constrains its ability to make such a waiver."

16See Comment to Model Rule of Professional Conduct 1.7 ("A possible conflict does not itself preclude the representation. The critical questions are the likelihood that a conflict will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclosed courses of action that reasonably should be pursued on behalf of the client.") The Model Rules eliminated the old "appearance of impropriety" standard. In re Glenn Electric Sales Corp., 99 B.R. 596 (D.N.J. 1988).


19Id.; Model Rule 1.13(b); In re Angelika Films 57th Inc., 227 B.R. 29 (S.D.N.Y. 1998)(interests of principal placed before entity); In re Tezlaff, 31 B.R. 560 (Bankr. E.D. Wis. 1983) (court recognizes difficult to draw line between individual and closely held corporation); In re Kendavis Industries International, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988); see also In re Downtown Investment Club III, 89 B.R. 59 (Bankr. 9th Cir. 1988)(plan modification benefiting general partner at expense of other creditors established conflict in representing general partner and partnership); In re McNar, Inc., 116 B.R. 746 (Bankr. S.D. Cal. 1990) (attorney improperly took direction only from one shareholder, when other shareholder opposed to actions).


bankruptcies are likely to generate conflicts when partners, previously represented jointly, disagree on the need for filing.22

Courts have differed in their approach to DIP counsel disqualification in affiliated entity cases. Some courts are strictly construing disinterestedness requirements of Bankruptcy Code sections 327, 328(c), and 1107(b), and disqualifying counsel based on the potential for conflicts and appearance that dual loyalty may exist.23 Others have disqualified counsel from representing related entities on evidence of actual adverse interests among them.24 Some courts have required such evidence of actual adversity before disqualifying joint counsel, deeming this a more flexible approach to economic and efficient estate administration, especially if full disclosure is made initially.25 Ethical rules authorize counsel to represent an organization and counseled partners on "claims" v. "interests"); In re McKinney Ranch Associates, 62 B.R. 249 (Bankr. C.D. Cal. 1986) (counsel disqualified from representing limited partnership debtor while representing general partners, but authorized to represent debtor after withdrawing from partner representation).


24In re Interwest Business Equipment, Inc., 23 F.3d 311 (10th Cir. 1994); In re RKC Development Corp., 205 B.R. 869 (Bankr. S.D. Ohio 1997); In re First Ambulance Center of Tennessee, Inc., 181 B.R. 323 (Bankr. M.D. Tenn. 1995); In re Green Street, 132 B.R. 460 (Bankr. D. Utah 1991)(inter-estate claims created per se conflict); In re Chou-Chen Chemicals, Inc., 31 B.R. 842 (Bankr. W.D. Ky. 1983) (cannot represent both DIP corporation and shareholder seeking control of it); Sambo's Restaurants, 20 B.R. at 307 (DIP counsel disqualified due to representation of preferred stockholders with interests adverse to common stockholders); Roberts, 46 B.R. at 848-49 (cannot represent DIPs owing each other); In re Watson Seafood & Poultry Co., 40 B.R. 436 (Bankr. E.D.N.C. 1984); In re Baldwin-United Corp., 45 B.R. 378 (Bankr. S.D. Ohio 1983) (may not represent DIP and non-management directors in securities litigation due to potential cross-claims); see In re N.S. Garrott & Sons, 63 B.R. 189 (Bankr. E.D. Ark. 1986) (describing conflicts resulting from representing related entities, one insolvent and indebted to the other solvent debtor, in Chapter 11 cases). See also In re Freedom Solar Center, Inc., 776 F.2d 14 (1st Cir. 1985) (attorney disqualified from representing Ch. 7 debtor along with its sole shareholder and another corporation owned by the same shareholder which was purchasing the estate's assets). One court has adopted a presumption against a single law firm, trustee or creditors' committee in most related debtor cases. In re Lee, 94 B.R. 172 (Bankr. C.D. Cal. 1988).

also its constituents, such as its shareholders, when the representation of one will not adversely affect the other. According to at least one court, representation of more than one entity is “an ethical trap” where the only truly safe harbor is to represent only a single client in bankruptcy.

Concerns that joint counsel for related debtors might not vigorously pursue claims of one against the other may also be addressed through hiring special counsel to evaluate and pursue inter-estate claims, or employing an examiner to evaluate them.

C. Attorney Direction by Management.

A number of bankruptcy courts have disqualified counsel for the DIP on the grounds that the attorneys are or may be more loyal to shareholder management or partners than to the debtor entity, because they also represent that management or those partners. This reason for disqualification has been given both when the insiders are debtors in their own bankruptcy


26Model Rules 1.13, 1.7. In dealing with the entity's constituents, counsel is to explain the identity of his client, the organization, when it is apparent that the interests are adverse. Model Rule 1.13(d).


28In re Global Marine, Inc., 108 B.R. at 1004; In re Chicago South Shore and South Bend R.R., 101 B.R. 10 (Bankr. N.D. Ill. 1989); In re Jartran, Inc., 78 B.R. 524 (Bankr. N.D. Ill. 1987); In re Hurst Lincoln Mercury, Inc., 80 B.R. 894 (Bankr. S.D. Ohio 1987); In re O'Connor, 52 B.R. 892 (Bankr. W.D. Okla. 1985); but see In re Amdura Corp., 121 B.R. 862 (Bankr. D. Colo. 1990)(relationship of firm to party adverse to debtor, and adverse party's role in the case, may be so important special counsel cannot relieve the problem). Special counsel need be disinterested only with respect to the matter on which such attorney is to be employed. 11 U.S.C. § 327(e); see In re RPC Corp., 114 B.R. 116 (M.D. N.C. 1990)(special counsel can represent DIP and former CEO and creditor of estate in lender liability action where interests are identical).
cases, and when the insiders have not filed. Some courts address disqualification on this ground case by case, expressly deciding without a per se rule.

Although insider management may have its own agenda, counsel for an entity must nonetheless take her direction from that very management. Counsel should not be disqualified for doing what is ethically required; if management breaches fiduciary duties it should be ordered replaced, and counsel should be sanctioned only to the extent of any Rule 9011 violation. When counsel furthers management violations of fiduciary duties and self dealing efforts, fee sanctions are likely, however.

29In re Occidental Financial Group, Inc., 40 F.3d 1059 (9th Cir. 1994); In re W.F. Development Corp., 905 F.2d 883 (5th Cir. 1990)(cannot represent limited and general partners in bankruptcy); In re Westwood Homes, Inc., 157 B.R. 182 (Bankr. D. Me. 1993); In re Churchfield Management & Investment Corp., 100 B.R. 389 (Bankr. N.D. Ill. 1989)(insider was power behind the debtor, although not named as an officer or director; In re Parkway Calabasas, 89 B.R. 832 (Bankr. C.D. Cal. 1988); In re Lee, 94 B.R. 172 (Bankr. C.D. Cal. 1988); In re A.I. Gelato Continental Desserts, Inc., 99 B.R. 404 (Bankr. N.D. Ill. 1989).


Connections by other DIP professionals to management and insiders may likewise be disqualifying and adversely affect reorganization efforts.33

D. Fee-Related Disqualification.

Payment of fees by third parties is expressly sanctioned by the Model Rules of Professional Conduct, as long as client consent is obtained, client confidentiality protected, and no interference is imposed on the lawyer’s independent professional judgment or lawyer-client relationship.34 Payment to a lawyer by a third party is not uncommon, with payments frequently being made by insurance carriers, prepaid legal plans, employers and parents.35

Several courts have recognized that fee payment from sources other than the debtor may subject counsel to the temptation of furthering the payor’s interests and deviating from the duty of undivided loyalty to the real client.36

Some courts have allowed the DIP’s partners or shareholders to protect their investment by individually paying or guaranteeing the DIP’s attorneys’ fees,37 even if the related entity is also a creditor.38 But one court has stricken such guarantees from fee agreements.39 Other courts have terminated counsel’s representation because of the appearance of conflict and potential for conflict when the motives of the retainer payor are suspect in light of creditor status and other entanglements with the estate.40

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34 Model Rule of Professional Conduct 1.8(f); comment to Model Rule 1.7.
35 See In re Boh! Risodorante, Inc., 99 B.R. 971 (9th Cir. BAP 1989) (gift from ex-wife).
38 In re Forbes Property Management, L.L.C., 252 B.R. 171 (Bankr. D. Colo. 2000) (special counsel);
40 In re City Matters, Inc., 163 B.R. 687 (Bankr. W.D.N.Y. 1994) (meeting on property owned by debtor's principals and leased to debtor);
41 In re Waterfall Village of Atlanta, Inc., 103 B.R. 340 (Bankr. N.D. Ga. 1989) (fees paid by entity that owned and controlled debtor in single asset case);
45 In re Rabex Amaru of North Carolina, Inc., 198 B.R. 892 (Bankr. M.D.N.C. 1996); In re Crivello, 194 B.R. 463 (Bankr. E.D. Wis. 1996); In re Adam Furniture Industries, Inc., 158 B.R. 291 (Bankr. S.D. Ga. 1993) (fees received from entities subject to avoidance and recovery actions by the estate); In re Black Hills...
third party is an actual conflict of interest disqualifying a professional from employment “absent a showing that the interests of the third party and the bankruptcy estate are identical” upon notice to all parties.\textsuperscript{41}

Disqualification due to third party fee payments or guaranties reduces the likelihood that competent counsel can be retained in some Chapter 11 cases. The estate may be fully liened; Section 506(c) collateral surcharges may be limited by the court;\textsuperscript{42} counsel risks her initial case evaluation proving overly optimistic, but not being allowed to withdraw.\textsuperscript{43}

A security interest on the estate’s unencumbered or under-encumbered assets to help assure fee payment may be allowed by some courts, after a thorough review of all the circumstances by the court.\textsuperscript{44}

A retainer may result in a disqualifying conflict of interest if it is obtained without authorization from a secured lender’s cash collateral.\textsuperscript{45} A fee agreement providing that counsel

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42 In re Flagstaff Food Service Corp., 739 F.2d 73 (2d Cir. 1984); In re Grant Associates, 154 B.R. 836 (S.D.N.Y. 1993)(DIP counsel entitled to surcharge rental income cash collateral only to extent creditor benefited); see extensive citations in In re CD Electric Co., 146 B.R. 786 (Bankr. N.D. Ind. 1992).
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44 In re Martin, 817 F.2d 175 (1st Cir. 1987)(not per se invalid; numerous factors listed for court review); see In re Printcrafter, Inc., 208 B.R. 968 (Bankr. D. Colo. 1997)(security interest in retainer precludes disinterestedness); In re City Mattress, Inc., 163 B.R. 687 (Bankr. W.D.N.Y. 1994); In re Quincy Air Cargo, Inc., 155 B.R. 193 (C.D. Ill. 1993)(security interest in vehicles permissible); In re Gilmore, 127 B.R. 406 (Bankr. M.D. Tenn. 1991)(bond in lieu of retainer given without creditor objection and with attorney agreement not to invade bond absent court permission); In re Carter, 116 B.R. 123 (E.D. Wisc. 1990)(attorney could secure bankruptcy-related fees with assignment of land contract vendor's interest in debtor's real estate, although he became a creditor upon perfection of the security interest); but see In re Pierce, 809 F.2d 1356 (8th Cir. 1987) (attorneys' prepetition mortgage on estate assets disqualifying); In re Escalera, 171 B.R. 107 (Bankr. E.D. Wa. 1994)(same, refusing to follow Martin); In re Automend, Inc., 85 B.R. 173 (Bankr. N.D. Ga. 1988)(security interest in accounts receivable disallowed, due to increased likelihood of potential conflict becoming actual and appearance of overreaching); In re Whitman, 51 B.R. 502 (Bankr. D. Mass. 1985)(fee disgorgement required where fees paid upon sale of asset subject to undisclosed attorney lien). Counsel should comply with Model Rule 1.8 in documenting any such transaction. A prepetition secured claim for fees unrelated to the current bankruptcy case is disqualifying.
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In re CIC Investment Corp., 175 B.R. 52 (9th Cir. BAP 1994). See also In re Mahendra, 131 F.3d 750 (8th Cir. 1997)(prepetition security interest in property ceased upon bankruptcy under state law; lien for prepetition fees earned is disqualifying adverse interest).
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may dismiss or convert the case if money is not regularly escrowed for fees causes a disqualifying potential adverse interest between lawyer and client.\textsuperscript{46}

Although some courts assert authority over any payment counsel receives from any source pursuant to Section 329,\textsuperscript{47} the Fifth Circuit has ruled that the bankruptcy court had no right to require disgorgement by DIP counsel of non-estate funds, even if paid by the debtor, for services unrelated to the bankruptcy case.\textsuperscript{48} And pre-bankruptcy payment for non-bankruptcy work is not subject to disgorgement, as long as there is no preference.\textsuperscript{49} While bankruptcy fee payment by a third party guarantor must be disclosed and the guaranty arrangement approved, some courts have held that fee applications need not be filed before the guarantor pays;\textsuperscript{50} others require such applications.\textsuperscript{51} An agreement by creditors to pay bonuses based on an examiner’s results must be disclosed, and may render the examiner no longer disinterested.\textsuperscript{52} A success fee for assistance to certain creditors may be held payable from those creditors’ recovery alone.\textsuperscript{53}

Courts are divided on disqualifying DIP counsel due to non-bankruptcy related unpaid prepetition fees. Most – including all circuit courts – strictly construe Section 327(a) to mandate disqualification as a creditor.\textsuperscript{54} A number of cases disqualifying on grounds of such

\textsuperscript{45} In re Smitty's Truck Stop, Inc., 210 B.R. 844 (10th Cir. BAP 1997).
\textsuperscript{46} In re Craig, 265 B.R. 624 (Bankr. M.D. Fla. 2001).
\textsuperscript{47} In re Downs, 103 F.3d 472 (6th Cir. 1996) (retainer from third party to be held in trust in which estate has interest); In re Land, 138 B.R. 66 (D. Neb. 1992), aff'd. without opinion, 994 F.2d 843 (8th Cir. 1993), reported in full, 1993 U.S. App. LEXIS 11348 (8th Cir. 1993); In re Land, 116 B.R. 798 (D. Colo. 1990), aff'd, remanded, 943 F.2d 1265 (10th Cir. 1991); In re Hathaway Ranch Partnership, 116 B.R. 208 (Bankr. C.D. Cal. 1990); In re Boh! Ristorante, Inc., 99 B.R. 971 (9th Cir. BAP 1989); Senior G & A Operating, 97 B.R. 307 (Bankr. W.D. La. 1989); In re Furniture Corp., 34 B.R. 46 (Bankr. S.D. Fla. 1983).
\textsuperscript{50} David & Hagner, P.C. v. DHP, Inc., 171 B.R. 429 (D.D.C. 1994) aff'd, 70 F.3d 637 (D.C. Cir. 1995); see In re Engel, 124 F.3d 567 (3d Cir. 1997)(DIP must obtain court approval to retain any attorney, even criminal, regardless of source of compensation); In re W.T. Mayfield Sons Trucking Co., Inc., 225 B.R. 818 (Bankr. N.D. Ga. 1998); but see In re Independent Engineering Co., Inc., 232 B.R. 529 (1st Cir. BAP 1999)(must disclose draws against retainer from non-debtor); see In re Metropolitan Environmental, Inc., 293 B.R. 871 (Bankr. N.D. Ohio 2003) (disclose guaranty even if contingencies to draw on the guaranty have not arisen).
\textsuperscript{51} In re Independent Engineering Co., Inc., 197 F.3d 13 (1st Cir. 1999).
\textsuperscript{53} In re Farmland Industries, Inc., 296 B.R. 188 (8th Cir. BAP 2003).
creditor status involve failure to disclose the creditor status initially and additional conflicts.\textsuperscript{55} A few courts have concluded that the Section 1107(b) exemption from the disinterestedness requirement of Section 327(a) includes an exemption for any professional who is a creditor solely because of prepetition employment on behalf of the DIP.\textsuperscript{56} Or they have allowed creditor professionals to serve the DIP as a matter of discretion based on the needs of the case, but those cases did not withstand appellate security.\textsuperscript{57}

Prepetition receipt of fees subject to avoidance as a preference creates a disqualifying conflict of interest.\textsuperscript{58} A firm may be held not disinterested if fees paid to an individual member as a receiver or trustee in fact belong to the firm.\textsuperscript{59}

E. DIP’s Counsel’s Representation of the Estate’s Creditors.

A professional is not disqualified as DIP counsel solely because of employment by a creditor under the Bankruptcy Code, absent objection by another creditor or the U. S. Trustee, whereupon the court is to disapprove the employment if an actual conflict of interest exists.\textsuperscript{60} That section of the Bankruptcy Code was amended in 1984. Prior to the amendment, it stated that the professional could not, while representing the trustee [or DIP] represent a creditor in connection with the case. The option to represent both now appears open in the absence of an actual conflict, e.g. in the case of an anticipated plan paying creditors in full, a fully secured creditor with collateral the debtor plans to give up, or an insider creditor willing to accept

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\item 1986); In re Boro Recycling, Inc., 67 B.R. 3 (Bankr. E.D. N.Y. 1986).
\item 11 U.S.C. § 327(c); In re Zenith Electronics Corp., 241 B.R. 92 (Bankr. D. Del. 1999)(prior representation of creditor/shareholder against debtor is actual conflict, and cannot be waived (by equity committee) when objection is made).
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subordinated treatment.\textsuperscript{61} If a former client creditor objects and the matters are substantially related, the bankruptcy court may enforce ethical code prohibitions on representation.\textsuperscript{62} Creditors’ counsel often has been allowed to represent the estate as special counsel to pursue matters where the estate and creditor have a common interest.\textsuperscript{63}

Even under the present, more liberal version of Section 327(c), courts have not allowed counsel to actively represent a creditor in the same bankruptcy case in which the trustee or DIP is represented, at least without full disclosure and an opportunity to object.\textsuperscript{64} And even where DIP counsel is not representing the creditor in connection with the bankruptcy case, allegiance to a creditor client may be considered to preclude counsel from investigating preferences, fraudulent conveyances, and so forth adequately, and to inhibit effective negotiation of a reorganization plan.\textsuperscript{65}


\textsuperscript{65} \textit{In re Cook}, 223 B.R. 782 (10th Cir. BAP 1998)(contingency fee agreement with creditor increased risk of alignment with creditor interest adverse to trustee he also represented and incentive to shift assets among related estates); \textit{In re Granite Partners, L.P.}, 219 B.R. 22 (Bankr. S.D.N.Y. 1998); \textit{In re Enviroydne Industries, Inc.}, 150 B.R. 1008 (Bankr. N.D. Ill. 1993); \textit{In re American Printers & Lithographers, Inc.}, 148 B.R. 862 (Bankr. N.D. Ill. 1992); \textit{In re Amdura}, 121 B.R. 862 (Bankr. D. Colo. 1990) and 139 B.R. 963 (Bankr. D. Colo. 1992)(creditor may play such a key role in the case, and represent such an important part of the law firm's fees, that even having separate counsel for the creditor in the bankruptcy case would be an inadequate solution to the conflict); \textit{Matter of Status Game Corp.}, 102 B.R. 19 (Bankr. D. Conn. 1989)(law firm that represented undersecured creditor holding substantial claim was disqualified as counsel for debtor, even though representation of creditor was on matters unrelated to case); but see \textit{In re Marvel Entertainment Group, Inc.}, 140 F.3d 463 (3d Cir. 1998)(representation on minor, unrelated matter not disqualifying); \textit{In re Dynamark, Ltd.}, 137 B.R. 380 (Bankr. S.D. Cal. 1992)(DIP counsel's firm vigorously represented DIP while representing major secured creditor on unrelated matters); see \textit{In re W.T. Grant Co.}, 699 F.2d 599, 613 (2d Cir. 1983)(5 days of representing creditors \textit{de minimus}, and does not require disqualification of trustee's counsel); \textit{In re Fondiller}, 15 B.R. 890, 892 (9th Cir. BAP 1981) (pre-1984 version of § 327(c), court finds
Model Rule of Professional Conduct 1.7 provides that a lawyer shall not represent a client if the representation will be directly adverse to another client or materially limited by the lawyer’s responsibilities to another client unless (1) the lawyer reasonably believes the representation will not adversely affect the relationship and (2) each client consents after consultation, which shall include an explanation of the implications of common representation and the advantages and risks involved.66

Model Rule of Professional Conduct 2.2 provides that a lawyer may act as an intermediary between clients if (1) he consults with each about the implications of common representation, including the advantages and risks, and effect on attorney-client privileges, and obtains each client’s consent; (2) the lawyer reasonably believes the matter can be resolved on terms compatible with the clients’ best interests, each will be able to make adequately informed decisions, and there is little risk of material prejudice if the contemplated resolution is unsuccessful; and (3) the lawyer reasonably believes the common representation can be undertaken impartially and without improper effect on the responsibilities the lawyer has to the clients. The lawyer is to consult with each client throughout the representation to enable their adequately informed decisions, and is to withdraw if any of the clients requests or if any of the conditions warranting ethical joint representation is no longer satisfied. At that point the lawyer may not continue to represent any of the clients.

F. Attorney’s Ownership Interest in the DIP and Serving as Officer or Director.

An “insider” and an “equity security holder” are not “disinterested.”67 An “insider” includes a general partner of the debtor, and a director or officer of a debtor corporation.68 Some courts have allowed counsel or other professionals to represent the DIP despite a small number of shares of the publicly traded debtor being held by a firm member.69 But other courts
have been much more strict, requiring disqualification despite firm attorneys’ ownership of only a small percentage of the outstanding equity shares of the DIP,\textsuperscript{70} and despite firm members holding only the office of secretary to facilitate documentation of transactions.\textsuperscript{71} Most cases disqualifying counsel on these grounds involve larger equity roles in privately held debtors and service on the board directly and indirectly controlling the company.\textsuperscript{72} Counsel’s actions during the case, including running for office and placing people on the board of directors, may make him into an insider.\textsuperscript{73}

G. Effectiveness of Curative Measures.

Bankruptcy courts have often imputed disqualification of a single attorney in a firm to the entire firm, applying the imputed knowledge principle of professional responsibility rules,\textsuperscript{74} generally without analysis.\textsuperscript{75} Recent well-reasoned decisions, however, conclude that disqualification should not be imputed to the entire firm if a lawyer is deemed not disinterested for non-conflict reasons, such as prior service as a director or officer of the debtor.\textsuperscript{76} Screening

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of a lawyer who advised a former client creditor through implementation of an “Ethical Wall” may also suffice to waive any conflict disqualification. However, the Delaware Bankruptcy Court has refused to allow such creative measures, in part because in light of the current climate of distrusting officers and directors, it is entirely possible that all officers of the debtor may be at least interrogated, and the firm would be placed in an untenable position of deciding to question one of the partners.

Several courts have allowed counsel to overcome disinterestedness concerns and represent a DIP if curative measures are taken to resolve non-disinterestedness status after full disclosure, such as such as sale of shares in the DIP company or resignation from the board of directors or an officership of the company and recusal from board deliberations, ceasing to represent an affiliated party, or returning possibly preferential fee payments. Appointment of special counsel to deal with conflict-related claims may suffice. Other courts have such actions unavailing.

In several instances, courts have also allowed counsel to represent the DIP despite status as a creditor, if the attorney waives the claim. Again, other courts refuse to sanction such

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proposals, and a few courts have allowed counsel to represent the DIP without requiring any corrective action.

Some courts have also allowed counsel to represent the DIP despite failure initially to seek court approval for the appointment, *nunc pro tunc*. Others have flatly disallowed fees for services performed prior to or without a court appointment order. Fees cannot be awarded on a *quantum meruit* basis or substantial contribution basis unless court approval of employment is obtained, initially or *nunc pro tunc* where such retroactive relief is available.

H. Disclosure is Mandatory.

Bankruptcy Rule 2014 requires disclosure of “any proposed arrangements 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 rule is much more comprehensive than the applicable statutes, 11 U.S.C. §§ 327 and 1103.

“Connections” has been broadly construed. Courts have cautioned that it is not for the DIP or its counsel to determine unilaterally whether a connection is relevant; the court is to review all connections and decide whether there are any disqualifying conflicts.

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85 E.g. *In re THC Financial Corp.*, 837 F.2d 389 (9th Cir. 1988); *Matter of Triangle Chemicals*, 697 F.2d 1280 (5th Cir. 1983); *In re Land*, 943 F.2d 1265 (10th Cir. 1991); *In re Arkansas Co.*, 798 F.2d 645 (3d Cir. 1986); *F/S Airlease II, Inc. v. Sunon*, 844 F.2d 99 (3d Cir.) cert. denied, 109 S.Ct. 137 (1988); *In re Mehdipour*, 202 B.R. 474 (9th Cir. BAP 1996).
87 *In re Milwaukee Engraving Co., Inc.*, 219 F.3d 635 (7th Cir. 2000); *In re Keren Ltd. P’ship*, 189 F.3d 86 (2d Cir. 1999); *In re Occidental Financial Group, Inc.*, 40 F.3d 1059 (9th Cir. 1994); *In re Weibel*, 176 B.R. 209 (9th Cir. BAP 1994). See *In re Bolton-Emerson, Inc.*, 200 B.R. 725 (D. Mass. 1996)(valid § 327 appointment order is condition precedent to compensation); *In re Famous Restaurants, Inc.*, 205 B.R. 922 (Bankr. D. Ariz. 1996) (§ 327 appointment order required for § 506(c) surcharge).
89 See, e.g. *In re Hot Tin Roof, Inc.*, 205 B.R. 1000 (1st Cir. BAP 1997); *In re Condor Systems, Inc.*, 302 B.R. 55 (Bankr. N.D. Cal. 2003) (separate business venture negotiations with debtors shareholders is a connection that must be disclosed); *In re C&C Demo, Inc.*, 273 B.R. 502 (Bankr. E.D. Tex. 2001) (and cases
Some courts have said that even the most trivial and attenuated and outdated connections must be disclosed. But despite the broad directives, the actual connections on which courts have focused in cases sanctioning professionals for nondisclosure of connections (even without damage to the estate) have been within the legitimate scope of inquiry under the applicable statutory standard. At least one court expressly recognized that connections which are meaningless under the statutory tests for employment approval need not be disclosed. In Rusty Jones, the court noted it was not necessary for the debtor’s counsel to disclose he had owned a hot dog stand 20 years before with one of the debtor’s indirect owners, because that connection was remote, de minimus and irrelevant to a § 327 analysis.

What is important are connections that presently exist or recently existed between the attorney and the parties in interest, and also past connections of business or personal nature that are either related to the bankruptcy proceedings or could reasonably have an effect on the attorney’s judgment in the case.

Id. The same principle was indirectly recognized by the Second Circuit in Arlan’s Dep’t. Stores. DIP counsel argued in Arlan’s that the predecessor to Rule 2014 required “disclosure only of present ‘connections’ that are ‘adverse to the debtor’” and that “every large New York firm has had prior relations with almost every other large New York firm, and to require the specification of all of these past associations would engulf the court in trivia.” The court responded that the undisclosed fee sharing agreement at issue in the case was a connection that was “hardly trivia,” and indeed could reasonably be construed as “trafficking in bankruptcy appointments,” implicitly acknowledging that normal professional and social relationships among professionals do not warrant disclosure.

The bottom line is that the court may assume misplaced loyalties and other dire results of direct and indirect connections, and assume the worst motives and results of potential
litigation. It may assume potential conflicts will become actual conflicts. The test for disclosure is not whether counsel believes the connection to be de minimus; the test is whether the connection is relevant to the statutory standards, should the court conclude it is significant instead of trivial. As the court put it in Rusty Jones, it is not enough that the attorneys did not feel a conflict existed; “it should have been apparent from …the connections…that conflicts of interest would at least be an issue.” In Hathaway Ranch Partnership, the court phrased it as “all facts that may be pertinent to a court’s determination of whether an attorney is disinterested or holds an adverse interest to the estate.”

Once the relevancy threshold for disclosure of even de minimus connections is met, sufficient information needs to be disclosed to enable the court to judge whether the connection is disqualifying. The disclosures have to be sufficiently detailed to enable the court to understand the magnitude of the connections and potential conflicts, and must be strictly accurate.

An employment application with full disclosure must be made for each professional firm employed; undisclosed subcontracting is impermissible. Disclosure through the schedules

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96 134 B.R. at 345.
97 In re Hathaway Ranch Partnership, 116 B.R. 208, 219 (Bankr. C.D. Cal. 1990); See Begun, 162 B.R. at 177 (duty “to reveal any interest which may be antagonistic or opposite to the interest of the estate”).
and statement of affairs, an exhibit to the petition, testimony at the first meeting of creditors, or monthly operating report entries is inadequate. The court has no duty to search the file and ferret out information on conflicts.100

Disclosure is an ongoing responsibility. If potential conflicts arise after the initial application and disclosure, they should be brought to the court’s attention promptly.101

Attorneys representing DIPs prepare pleadings for their client’s signature, including applications for their own employment. They are obliged to inquire into and analyze the factual and legal elements of every document signed and filed.102 A half-hearted inquiry into conflicts among firm members is inadequate. It is counsel’s responsibility to ensure complete disclosure.103 Special counsel cannot simply rely on the DIP’s primary bankruptcy counsel to handle necessary filings.104

102 Bankruptcy Rule 9011; In re Pierce, 809 F.2d 1356 (8th Cir. 1987) (applying Rule 9011 to erroneous application to employ counsel); In re Jacobsen, 47 B.R. 476 (D. Colo. 1985); In re Dreiling, 233 B.R. 848, 870 (Bankr. D. Colo. 1999)(fundamental premise of our judicial system is that attorneys are officers of the court; when they address a judge it is virtually made under oath); Model Rule 3.1 and comment.
103 See In re Thrifty Oil Co., 205 B.R. 1009 (Bankr. S.D. Cal. 1997) (accounting firm's conflict check inadequate); In re Perry, 194 B.R. 875 (E.D. Cal. 1996)(trustee's attorney failed to conflict check purchaser of estate assets -- represented by own firm); In re Michigan General Corp., 78 B.R. 479, 482 (Bankr. N.D. Tex. 1987)("Unfortunately, the burdens of the Bankruptcy Code are not met by a white heart. Negligence does not excuse the failure to disclose a possible conflict of interests."); In re Kelton Motors, Inc., 109 B.R. 641, 649 (Bankr. D. Vt. 1989)("attorney's ethical duty to inform the Court of the existence of possible ethical violations").
Full disclosure of all aspects of fee arrangements is also required. Complete disclosure of prepetition payments “in connection with” and “in contemplation of” bankruptcy must be disclosed, in addition to disclosure of retainer arrangements.

I. Sanctions for Conflicts and Failure to Disclose Potential Bases for Disqualification.

The most common consequence of non-disinterestedness is termination of the representation, with fee denial or disgorgement of interim payments, but suspension from practice, disbarment, and even criminal convictions have been imposed for blatant non-disclosure violations. The court may disqualify counsel from representing the DIP based upon an objective standard, evaluating the facts of each case, regardless of the integrity or intent of the attorney.

The Bankruptcy Code specifically authorizes—but does not require—courts to deny fees and reimbursement of expenses if at any time during the employment, the attorney is not disinterested or holds or represents an interest adverse to the estate with respect to the matter for which the attorney is employed. If the attorney was never appointed as counsel, and is not disinterested or otherwise not entitled to nunc pro tunc employment, the court cannot award fees on grounds of quantum meruit, a substantial contribution to the case, or other equitable

105 In re Big Rivers Electric Corp., 2004 WL 34848 (6th Cir. 2004); In re Kisseberth, 273 F.3d 714 (6th Cir. 2001); In re Lewis, 113 F.3d 1040 (9th Cir. 1997); In re Downs, 103 F.3d 472 (6th Cir. 1996)(disgorgement of all fees mandatory); In re Park-Helena Corp., 63 F.3d 877 (9th Cir. 1995) cert. denied, 116 S. Ct. 712 (1996)(strict compliance); In re Pierce, 809 F.2d 1356 (8th Cir. 1987); In re Arlans Departments Stores, Inc., 615 F.2d 925 (2d Cir. 1979); In re Soldanelli, 230 B.R. 54 (M.D. Pa. 1999)(disclose retainer given after court approval of retention and source of pre-approval retainer); In re Independent Engineering Co., Inc., 232 B.R. 529 (1st Cir. BAP 1999)(disclose draws against retainer supplied by non-debtor and nature of fee agreement); In re Metropolitan Environmental, Inc., 293 B.R. 439 and 213 B.R. 129 (Bankr. E.D. Mich. 1997), aff’d in relevant part Halbert v. Yousif, 225 B.R. 336 (E.D. Mich. 1998).


109 11 U.S.C. § 328(c); Gray v. English, 30 F.3d 1319 (10th Cir. 1994).
If the attorney was approved as counsel, and later found disqualified, courts are divided on their discretion to award or not award fees. In many reported cases, the courts appear to have denied payment of all fees to attorneys who did not meet disinterestedness requirements. Fee disallowance was imposed even when, in retrospect, no harm has been shown from the facts that should have

110 In re Albrecht, 233 F.3d 1258 (10th Cir. 2000); In re Milwaukee Engraving Co., 219 F.3d 635 (7th Cir. 2000) reversing 230 B.R. 370 (Bankr. E.D. Wis. 1998) and overruling In re Milwaukee Boiler Mfg. Co., 232 B.R. 122 (Bankr. E.D. Wis. 1999)(compensation for emergency services while employment application pending and before disallowance); In re Occidental Financial Group, Inc., 40 F.3d 1059 (9th Cir. 1994); In re Grubb Corp., 983 F.2d 773 (7th Cir. 1993); In re Monument Auto Detail, Inc., 9th Cir. BAP 1998); In re Weibel, 176 B.R. 209 (9th Cir. BAP 1994); In re Anicom, Inc., 273 B.R. 756 (Bankr. N.D. Ill. 2002); In re Stoico Restaurant Group, Inc., 271 B.R. 655 (Bankr. D. Kan. 2002); In re Encapsulation Intern., LLC, 226 B.R. 614 (Bankr. W.D. Tenn. 1998).


been disclosed.\textsuperscript{114} Other courts have not required total disgorgement when the need for attorney discipline is outweighed by the equities of the case.\textsuperscript{115} One court, explicitly exercising its discretion and flexibility to correct a situation, denied payment of additional fees until a plan providing for payment of 100\% of all creditors’ claims was confirmed and implemented, to avoid speculation as to actual harm caused by conflicting interests.\textsuperscript{116} Another accomplished a similar result by subordinating fees to unsecured creditors’ claims.\textsuperscript{117} Intentional nondisclosure may be treated as a fraud on the court, warranting denial of all compensation as a severe sanction, and ignoring other factors applicable in cases where concealment is not intentional.\textsuperscript{118} Nondisclosure harming the estate may be sanctioned without the court also finding a conflict of interest.\textsuperscript{119}

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\textsuperscript{116} In re Gay Apple Masonry Contractor, Inc., 45 B.R. 160 (Bankr. D. Ariz. 1984); see also In re Jartran, Inc., 78 B.R. 524 (Bankr. N.D. Ill. 1987)(court appointed examiner to evaluate alleged conflicting relationship, DIP claims against creditor represented by DIP counsel, and status of consensual plan alleged to obviate claim issue, then delayed appointment pending plan negotiations).
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The court may order fee disgorgement to the estate even if the fees were originally paid by third parties. Courts have also required disgorgement of fees received from the estate without prior court disclosure, and reduced fees for nondisclosure of all compensation arrangements.

DIP clients suffer repercussions from disqualification after the case is underway, as well. Withdrawal may require duplicative catch-up time of new counsel that a company in distress may not easily afford. The DIP may also suffer from the court’s vacating of critical orders obtained by disqualified counsel.

An evidentiary hearing is not required before a court requires disgorgement of fees on grounds of disqualification. Courts are divided on whether a decision to appoint or disqualify


124In re Land, 943 F.2d 1265 (10th Cir. 1991); In re Placid Oil Co., 158 B.R. 404 (N.D. Tex. 1993). There is inherent notice on a bankruptcy fee application that the ethical conduct of the attorney seeking fees is up for consideration. See In re Devers, 33 B.R. 793 (D.D.C. 1983), appeal dismissed, 729 F.2d 863 (D.C. Cir. 1984); In re Diamond Mortgage Corp. of Illinois, 135 B.R. 78 (Bankr. N.D. Ill. 1990); In re Kendavis
counsel or sanction counsel’s disqualification through reduced or disgorged fees on an interim basis is an interlocutory, non-appealable order.125

J. Conclusive Effect of Fee Award, and Indemnity, for Ethical Violations.

When a reorganization case fails, the Chapter 7 trustee and creditor body may seek to find the professionals at fault. In the Merry-Go-Round case, a malpractice suit against the restructuring accountants and business advisors was remanded from bankruptcy court to state court, then settled for $185 million.126

Objections to the quality of services provided, and their benefit to the bankruptcy estate, are considered by the court when awarding fees to a professional employed by the estate.127 If such objections are raised, or if they could have been raised, a fee award or disgorgement order thereafter has been held to bar later malpractice claims under the doctrine of res judicata.128

If a professional deliberately conceals evidence of ethical violations, the professional may nonetheless be charged with a claim of fraud on the court, despite an apparent release in a court order.129 A judgment may be set aside under Rule 60(b) at any time for fraud on the court.130 One court held it could set aside an order approving counsel’s employment and order disgorgement of fees awarded. It also held that the Chapter 7 trustee stated a claim for fraud on the court when the DIP’s counsel avowed no prior connections with the debtor and no adverse interest, when in fact it had represented the debtor’s general partners prepetition in setting up limited partnerships into which the debtor’s assets were transferred.131

Some DIP professionals have sought to include indemnity provisions in their engagement agreements, and to limit any damage claims to disgorgement of fees received.

Industries International, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988); but see § VIII B. A decision to appoint or disqualify counsel or sanction counsel’s disqualification through reduced or disgorged fees on an interim basis has been held to be an interlocutory, non-appealable order. In re Firstmark Corp., 46 F.3d 653 (7th Cir. 1995)(and cases cited therein).

125Compare In re Arochem Corp., 176 F.3d 610 (6th Cir. 1999)(final); In re BH&P, Inc., 949 F.2d 1300 (3d Cir. 1991)(same); In re A.H. Robins Co., 828 F.2d 239 (4th Cir. 1987)(same) with In re Firstmark Corp., 46 F.3d 653 (7th Cir. 1995) (not final); In re Devlieg, Inc., 56 F.3d 32 (7th Cir. 1995)(same); In re Westwood Shake & Shingle, Inc., 971 F.2d 387 (9th Cir. 1992)(same); In re Delta Servs. Indus., 782 F.2d 1267 (5th Cir. 1986)(same); In re Continental Inv. Corp., 637 F.2d 1 (1st Cir. 1980)(same); see In re Federated Department Stores, Inc., 44 F.3d 1310 (6th Cir. 1995) where an order refusing to disqualify a professional was appealed and reversed, despite conclusion of the case in the absence of a stay pending appeal.


128 In re Iannocino, 242 F.3d 36 (1st Cir. 2001); In re Intelogic Trace, Inc., 200 F.3d 382 (5th Cir. 2000); In re Southmark, 163 F.3d 925 (5th Cir. 1999).

129 Pearson v. First NH Mortgage Corp., 200 F.3d 30 (1st Cir. 1999).


Courts are divided in approving such indemnity language in accountant engagement agreements, with some agreeing if there is an exception for bad faith, self-dealing, willful or reckless misconduct or gross negligence.132 Efforts to divert the forum for malpractice claims to arbitrations or bankruptcy or federal court without a jury have likewise received mixed results to date.133 Professional conduct rules for attorneys prohibit agreements prospectively limiting liability to a client for malpractice unless the agreement is both permitted by law and the client is independently represented in making the agreement.134

The Third Circuit affirmed retention of the debtor’s financial advisor with an indemnity from the advisor’s own negligence in United Artists Theatre Co. v. Walton.135 The court evaluated the indemnity from a market perspective and noted that indemnities have become common after the Merry-Go-Round settlement of negligent claims against the debtor’s accountants.136 But being common does not make provisions reasonable as required under Code §328.137 The court evaluated reasonableness from the perspective of Delaware corporate law, focusing on the process of (1) having no personal interest; (2) having a reasonable awareness of all material information reasonably available after considering alternative options, and (3) providing advice in good faith.138 The court required that gross negligence be carved out of the indemnity, and rejected a contract term that would have required indemnity if gross negligence was not judicially determined to be the sole source of damages; contractual disputes were likewise carved out of the indemnity.139

134 Model Rule 1.8(h); Model Code DR 6-102(A).
135 315 F.3d 217 (3d Cir. 2003).
137 315 F.3d at 230.
138 315 F.3d at 232-33.
139 315 F3d at 23-33; see In re Baltimore Emergency Services II, LLC, 291 B.R. 382, 387-86 (Bankr. D. Md. 2003) following United Artists, and approving a financial advisor’s indemnity on the condition that a provision be changed that had required indemnification if damages were not found to have been primarily caused by gross negligence, and that may have provided for indemnity of contract disputes.