Ethics: You're Outta There! Avoiding Disqualification Landmines

Laura Davis Jones, Moderator
Pachulski Stang Ziehl & Jones; Wilmington, Del.

Stephen A. Donato
Bond Schoeneck & King PLLC; Syracuse, N.Y.

Cassandra M. Porter
Lowenstein Sander LLP; Roseland, N.J.

Hon. Laurie Selber Silverstein
U.S. Bankruptcy Court (D. Del.); Wilmington

Marc S. Weinsweig
WeinsweigAdvisors, LLC; Rockville, Md.

Ethics: Avoiding Disqualification Landmines

The overlay of the Bankruptcy Code's conflicts and disclosure requirements on state rules of professional responsibility, applied to restructuring professionals retained in circumstances that frequently may conservatively be described as "dynamic," creates an ethical minefield. This is particularly true for large firms employed by debtors and their creditors in large, complex chapter 11 cases.

The essential requirements appear simple enough: professionals that are to be employed by the estate must not hold or represent interests adverse to the estate, and must disclose all facts germane to that determination. In practice, however, these seemingly straight-forward requirements generate a host of overlapping factual and legal issues. These include: (a) whether counsel can concurrently represent debtors and their equity holders or affiliates of equity holders (or other interested parties); (b) whether counsel can represent multiple debtors within a corporate family; (c) when are individual conflicts of interest imputed to disqualify an entire firm; (d) whether ethical walls can prevent disqualification based on conflicts of interest; (e) whether client waivers help prevent disqualification; (f) to what extent can disqualification be prevented by employing special/conflicts counsel under section 327(e); (g) how payment of debtor's counsel's prepetition fees may create an adverse interest; (h) what disclosure defects will result in disqualification; and, importantly (i) what curative measures can be taken after the fact to rectify a disqualifying conflict. Can a representation be salvaged by making supplemental disclosures, constructing ethical walls, employing conflicts counsel, returning payments or releasing liens? As with any subject worth discussing, there are no certain answers.

Most often, bankruptcy professionals navigate this minefield successfully. Despite an abundance of authority, commentary and practice pointers on these subjects, however, all of these issues continue to surface regularly. In fact, two very recently decided cases, *Caesars Entertainment* in the Northern District of Illinois and *Karmaloop* in Delaware, implicate many of these issues, including the representation of equity holders or affiliates, imputation of conflicts, the efficacy of screening and waivers, the use of special counsel, preferential draw-downs, and how to cure conflicts.

Applicable Bankruptcy Code Requirements

The relevant requirements of the Bankruptcy Code are familiar. Section 327(a) requires that professionals employed to represent a debtor (1) do not hold or represent an interest adverse to the estate and (2) are "disinterested persons." 11 U.S.C. § 327(a). A "disinterested person" is defined under § 101(14) to include a person who "is not a creditor, an equity security holder, or an insider" and "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 for any other reason." 11 U.S.C. § 101(14).

To "hold an adverse interest" means: "(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 Project Orange Assocs., LLC*, 431 B.R. 363, 370 (Bankr. S.D.N.Y. 2010).Id. (internal quotation omitted). To "represent an adverse interest" means to serve as agent or attorney for an entity holding such an interest. *Id*. "A conflict is actual, and hence per se disqualifying, if it is likely that a professional will be placed in a position permitting it to favor one interest over an impermissibly conflicting interest." *In re BH&P, Inc*., 949 F.2d 1300, 1315 (3d Cir. 1991).

Pursuant to section 327(c) of the Bankruptcy Code, professionals are not disqualified solely due to employment by or representation of a creditor, so long as there is no actual conflict of interest. Similarly, section 1107(b) of the Bankruptcy Code permits professionals that have worked for the debtor prior to the commencement of the case to be eligible for post-petition retention so long as they satisfy the requirements of Section 327.

Section 327(e) permits a trustee or debtor in possession to employ attorneys for a "specified special purpose" other than to represent the trustee or debtor in possession "in conducting the case," provided that:

(a) The attorney has represented the debtor;

(b) Employment is in the best interest of the estate; and

(c) Such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.

Finally, Bankruptcy Rule 2014 requires professionals to be employed by the trustee, debtor or creditors' committee to disclose in a verified statement "all" of their connections to the following:

(a) Debtor and its attorneys and accountants;

(b) Creditors and their attorneys and accountants (usually the secured creditors and top 20 or 30 unsecured creditors);

(c) Parties in interest and their attorneys and accountants; and

(d) United States Trustee or any person employed by the United States Trustee.

Parties in interest that should be identified pursuant to Bankruptcy Rule 2014 may include (a) insiders (*i.e*., officers and directors), (b) indenture and bond trustees, (c) major shareholders, (d) major bondholders, (e) major contract parties, and (f) subsidiaries and affiliates of debtor.

Other matters and information that professionals must disclose are: (a) unpaid fees or prepetition claims (and the waiver of any prepetition claims) (b) fee arrangements (including the receipt of any retainer or payment by third parties) (11 U.S.C. § 329(a)); (c) amounts received during the preference period; (d) amounts held by professional in trust or as custodian; (e) joint defense agreements executed by professionals and parties that are adverse to the estate; (f) information concerning conflict waivers by major creditors; and (g) source of pre-petition retainer and involvement in negotiation of certain pre-petition agreements among debtors, affiliates and certain creditors. Professionals have a continuing duty to update or supplement their disclosures if potential conflicts arise.

Concurrent Representations of Equity Holder Affiliates – Caesars Entertainment Operating Company

On May 28, 2015, Judge Benjamin Goldgar of the Northern District of Illinois issued his decision approving the employment of Kirkland & Ellis as debtors' counsel in *In re Caesars Entertainment Operating Company, Inc*., Case No. 15-01145 (Bankr. N.D. Ill.). The case presented in primary part the issue of when the representation of affiliates of equity interest holders may constitute a disqualifying adverse interest. In lesser part (discussed separately below), it also presented the issue of whether K&E's retainer agreement protected postpetition drawdowns from avoidance, which might otherwise create an adverse interest.

The debtor in *Caesars*, CEOC, is majority owned by Caesars Entertainment Corporation ("CEC"). In turn, CEC is majority owned by four affiliates of its equity sponsors, Apollo and TPG. At the heart of the case is a challenge to billions of dollars of alleged fraudulent transfers, allegedly engineered by Apollo and TPG, made to or for the benefit of CEC and its direct and indirect equity sponsors, to the detriment of CEOC creditors.

K&E does not represent CEC, its controlling Apollo and TPG affiliates, or Apollo or TPG themselves. It does, however, concurrently represent other portfolio companies of Apollo and TPG on unrelated matters. K&E allegedly conceded that it derived 3.4% of its annual revenue last year on account of Apollo and TPG-related work (though that number may be erroneous).[1] Also, K&E was representing a TPG principal who is a CEOC and CEC director in unrelated securities litigation (but terminated that representation with that person's consent "out of an abundance of caution").

K&E's employment was challenged by certain junior noteholders. The central argument was that by virtue of its lucrative representation of affiliates of Apollo and TPG, K&E represents an interest adverse to the interests of CEOC's estate, and would be less likely to take positions that are adverse to Apollo and TPG, which control CEOC's and CEC's boards.[2] As evidence of bias, the noteholders pointed to pitch books in which K&E touted its success in keeping directors and officers out of harm's way. Further, they argued that an allegedly unfair new value Restructuring Support Agreement and proposed plan shows that K&E has already sided with the equity sponsors against CEOC creditors.

In response, K&E argued that since the concurrent representation of a debtor and its controlling shareholder is not in itself the representation of an adverse interest, and since it does not represent the parent (CEC), or the parent's controlling shareholders (the equity sponsor

[1] 3.4% of K&E annual fees does not square with K&E's description of the fees as *de minimis*, and the number is not referenced in the decision.

[2] CEOC's board has seven members. Of those, two are affiliated with Apollo, two are affiliated with TPG, and two are independent. (The seventh was not identified.) The CEOC board has a three-member executive committee. One member is affiliated with Apollo, another with TPG. Six of the nine CEC board members are also associated with Apollo or TPG.

affiliates), or even the equity sponsors themselves (Apollo and TPG), but only affiliates of the equity sponsors in unrelated matters, the offending representations were far too attenuated to warrant disqualification. This attenuation distinguished Caesars from cases in which counsel had concurrent representations of parties in interest in the same case.[3] K&E also stated that it obtained conflict waivers from its clients to ensure that it can sue any Apollo or TPG entity, and represented that it is regularly adverse to Apollo and TPG affiliates in other debtor representations. K&E argued that its revenues from its Apollo and TPG related work are *de minimis* and posited that a rule that such facts warrant disqualification would effectively preclude large firms from participating in the large and complex bankruptcy cases in which they are most needed (and attached a recent article in the ABI Journal authored by the attorneys making that very point).[4]

Judge Goldgar approved K&E's employment. In the May 28, 2015 *Order Granting the Debtors' Application to Retain Kirkland & Ellis LLP and Kirkland & Ellis International LLP as Counsel* (Docket No. 1713) (the "K&E Order"), the court rejected the proposition that disqualification requires an actual conflict; rather, the rule is that an actual conflict requires disqualification, while disqualification is permitted but not required when there is a potential conflict. *See In re Marvel Entm't Group, Inc*., 140 F.3d 463, 477 (3d Cir.1998); *In re Pillowtex, Inc*., 304 F.3d 246, 251 (3d Cir. 2002). The court concurred with the noteholders that "a professional holds or represents an interest adverse to the estate if he has a predisposition under circumstances giving him a bias against the estate." K&E Order at 9-10 (citing *In re Crivello*, 134 F.3d 831, 835 (7th Cir. 1998)).

The court placed great weight on the attenuated corporate relationship between CEC and its sponsor-related majority owners and the portfolio companies represented by K&E in unrelated matters. It emphasized that "Corporate separateness is a fundamental tenet of American law" and that the debtors and the parent entities "cannot be lumped together and treated as if they were a single enterprise doing Apollo and TPG's bidding – not without evidence of a kind the Committee did not present." *Id*. at 13. The court refused to infer that K&E would be biased. It recognized mixed authority on whether a debtor's counsel is permitted to represent its principal in unrelated matters (taking note of the ABI article arguing that permitting such employment "should be the norm" in chapter 11 mega-cases even when counsel "represents debtors and nondebtors in unrelated matters").[5]

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[3] Cases cited by the parties included *In re Envirodyne Indus., Inc*., 150 B.R. 1008, 1011-15 (Bankr. N.D. Ill. 1993) (firm could not simultaneously represent the debtor and Salomon Brothers, a majority shareholder and major creditor; counsel had represented Salomon in the challenged LBO that led to the bankruptcy; counsel admitted Salomon was a "significant client" and the firm's "inability to investigate claims relating to the LBO"; and counsel initially failed to disclose its connections to Salomon, the LBO, or its inability to investigate or litigate related claims); *In re Am. Printers & Lithographers, Inc*., 148 B.R. 862, 863-65 (Bankr. N.D. Ill. 1992) (firm could not simultaneously represent the debtor and LaSalle National Bank, the debtor's DIP lender and a significant secured creditor; LaSalle represented 10% of the firm's gross revenues); *In re Amdura Corp*., 121 B.R. 862, 864-67 (Bankr. D. Colo. 1990) (firm could not simultaneously represent debtor and key secured creditor which the firm described as "the hand that feeds").

[4] Bennett L. Spiegel & Monika S.Wiener, Concurrent Representation of Debtor and Nondebtor Equityholder, Am. Bankr. Inst. J., Feb. 2015, at 38-39.

[5] *Id*. at 14 (citing the Jones Day ABI Journal article at pp. 38-39).

> Kirkland, though, does not represent the debtor's principal – or the principal's principal, or even the principal of the principal's principal. Kirkland represents in unrelated matters companies in which Apollo and TPG, three layers of corporate ownership removed from CEOC, have an interest. Those attorney-client relationships are too remote from the bankruptcy cases to conclude that Kirkland would be predisposed to act adversely to the estates as a result of them.

Id. at 14. The court went on to evaluate the evidence alleged to show bias, such as the terms of the proposed plan, the pitch book, and certain litigation in which CEOC took a position that the disputed transactions were proper, and concluded that none showed that K&E was not disinterested. With respect to the pitch book, in particular, the court emphasized: "It was a promotional piece. An advertisement. A commercial. It was a way of saying: "Things go better with Kirkland."" *Id*. at 16.

Notably, the court concluded by observing that "[s]hould questions arise about CEOC's willingness to pursue claims belonging to the bankruptcy estates, there are better solutions than depriving CEOC of its choice of counsel. One of them is to grant derivative standing. [citations] Another is the retention of conflicts counsel. [citing, *inter alia*, *Project Orange Assocs*., 431 B.R. at 375] The debtors have applied to retain conflicts counsel, and that application will be granted." *Id*. at 16-17.

One objective factor not discussed in the K&E Order is the monetary significance of Apollo and TPG-related work to K&E. According to the noteholders, Apollo and TPG-related representations accounted for over 3.4% of K&E's revenue over the past year. That is a very large number for a firm of K&E's size, both as a percentage of total fees and in absolute terms. It stands to reason that the bigger the client, the more potential for bias. The 2013 Final Report of the ABI National Ethics Task Force,[6] in discussing the use of special counsel to overcome conflicts posed by representations of interested parties on unrelated parties, posited 1% as a possible benchmark for assessing whether such a conflict is material.

> Some courts view certain client representations as too "small" to trigger a problem. In fact, some courts have recognized a 1% rule: if a law firm's client represents less than 1% of that firm's billings, those courts have considered such a representation to be too inconsequential to warrant disqualification. That 1% rule, though, has its limitations. In 1985, shortly after the Bankruptcy Code began, the largest law firm's revenues were $129 million. Today, that same largest firm's annual revenues are $2.1 billion. One percent of that amount means annual billings of $21 million, a significant client by any measure, calling into question the

[6] Lois R. Lupica and Nancy B. Rapoport, Final Report of the ABI National Ethics Task Force 38 (2013) (the "ABI Ethics Report"), at 38 (citing NORTON ANNUAL SURVEY OF BANKRUPTCY LAW, Volume 2004, Issue 2004 at 3; In re Clark Retail Enterprises, Inc., 308 B.R. 869 (Bankr. N.D. Ill. 2004) (finding no actual conflict of interest where a firm represented debtor and its post-petition lender where the lender accounted for only 1.03% of the firm's annual revenue); In re Filene's Basement, Inc., 239 B.R. 850, 853 (Bankr. D. Mass. 1999)).

> continued use of the 1% rule. The Reporters point this out for consideration without reaching any conclusion about what threshold should apply.

ABI Ethics Report at p. 38.[7] Judge Goldgar's analysis was based on the absence of a *per se* prohibition against representing a debtor's principals, respect for corporate separateness, the attenuation of the offending representations, and the lack of evidence manifesting bias. There was no quantitative assessment of the monetary significance to the firm of the unrelated representations.

The legal analysis is the same when the joint representation directly involves the debtor's controlling shareholder, rather than affiliates thereof. It starts with whether there is an actual or potential conflict. "Simultaneous representation of a debtor corporation and the controlling shareholders, although not a disqualifying conflict per se, becomes a basis to disqualify counsel when adverse interests either exist or are likely to develop." *In re Jade Management Services*, 386 Fed.Appx. 145, 148 (3d Cir. 2010) (law firm found to be disinterested despite dual representation of company and sole shareholder who had guaranteed secured debt, where it was likely the debtor's estate would cover its secured debt).[8] *See also In re Boot Hill Biofuels LLC*, 2009 WL 982192 (Bankr. D.Kan. March 27, 2009) (approving debtor's counsel's concurrent representation in unrelated matters of controlling equityholder, which also had a management agreement with the debtor, where actual conflict might arise only if the equityholder's management of the debtor came into question or a contract dispute were to arise); *Magten Asset. Mgmt. Corp. v. Paul Hastings Janofsky & Walker LLP (In re Northwestern Corp.)*, 346 B.R. 84 (D. Del. 2006) (counsel's prior representation of the debtor and a subsidiary in an allegedly fraudulent asset transfer transaction raised only a potential conflict that did not merit disqualification).

Joint Representation of Affiliated Debtors

Courts regularly approve the employment of one firm to jointly represent all of the debtors in chapter 11 mega-cases involving complex webs of affiliated debtors and inter-company claims. As the joint representation of affiliated debtors often encompasses parent and subsidiary entities, there is considerable overlap in the issues and analysis generated by such representations.

Again, the threshold issue is typically whether the alleged conflict is actual or potential. For example, *In re BH&P* involved the bankruptcies of a corporation and its two principals. The Third Circuit held that the existence of interdebtor claims did not preclude a trustee and counsel

[7] *But see Premier Farms L.C.*, 305 B.R. 717, 719 (Bankr. N.D. Iowa 2003) (disqualifying law firm because of its current representation of creditor on unrelated matters, even though creditor provided less than 1% of the firm's annual revenue).

[8] Citing, *inter alia*, *In re Plaza Hotel Corp*., 111 B.R. 882, 890 (Bankr.E.D.Cal. 1990) and *TWI Int'l, Inc. v. Vanguard Oil Serv. Co*., 162 B.R. 672, 675 (S.D.N.Y. 1994) .

from administering all three cases (but affirmed the bankruptcy court's disqualification of the trustee and counsel on the particular facts of the case).[9]

Regarding the disqualification of counsel, the Third Circuit held that "[t]he existence of interdebtor claims is … no longer an automatic ground for disqualification of counsel for the trustee. Section 327 focuses the inquiry upon whether there is an actual conflict of interest." *Id*. at 1314. The court of appeal rejected a per se rule.

> This flexible approach will require the bankruptcy courts to analyze the factors present in any given case in order to determine whether the efficiency and economy which may favor multiple representation must yield to competing concerns affecting fairness to all parties involved and protection of the integrity of the bankruptcy process. Factors to be considered include, but are not limited to, the nature of disclosure of the conflict made at the time of appointment, whether the interests of the related estates are parallel or conflicting, and the nature of the interdebtor claims made. As we have said, denomination of a conflict as "potential" or "actual" and the decision concerning whether to disqualify a professional based upon that determination in situations not yet rising to the level of an actual conflict are matters committed to the bankruptcy court's sound exercise of discretion.

In re BH&P, Inc., 949 F.2d 1300, 1316-17 (3d Cir. 1991).

In re Adelphia Comm. Corp., 336 B.R. 610 (Bankr. S.D.N.Y. 2006), *aff'd* 342 B.R. 122 (S.D.N.Y. 2006) involved 231 debtors. One law firm was permitted to represent all of the debtor entities provided that counsel maintained neutrality as to disputes among them. So long as such disputes were not in litigation, any conflict was potential, and could be addressed through conflicts counsel in the event the conflict became actual. *Id*. at 672-73 (Bankr. S.D.N.Y. 2006) (observing that courts "have taken a 'wait-and-see,' fact-driven, approach" to determining whether separate counsel is necessary in recognition of "the substantial cost of requiring additional trustees or counsel in cases where individual debtors have claims against each other"). *See also In re Gilbertson Restaurants, LLC*, 2004 WL 1724878 (Bankr. N.D. Iowa, May 3, 2004) (permitting joint representation of multiple related debtors on basis that no actual conflict existed at time of retention and conflicts counsel could be retained if conflict became actual). "In cases where an identity of interest or unity of purpose exists between two bankruptcy estates, courts have not prohibited dual legal representation by counsel even when the two estates have landlord-tenant or debtor-creditor relationships." *In re Universal Enterprises of W. Va., LLC*, 2010 WL 2403354 (Bankr. N.D. W.Va. June 9, 2010).

Compare In re JMK Constr. Group, Ltd., 441 B.R. 222, 229 (Bankr. S.D.N.Y. 2010), in which a firm was barred from simultaneously representing a construction company, its principal,

[9] In *BH&P*, the trustee had filed proofs of claim and nondischargeability complaints against the principals. Two years later, the bankruptcy court decided the conflict was actual and disqualified the trustee and counsel. The court of appeal intimated that the decision was questionable but affirmed on the basis that the lower court did not abuse its discretion in finding an actual conflict.

and two other individuals, all of whom were defendants in a lawsuit in which they had been found liable, based upon the debtors' continuing right to seek contribution from each other on a damages award entered in a state court fraud action, and on the existence of inter-debtor claims for repayment of prepetition loans. The court characterized the representation as involving the simultaneous representation of debtors and creditors.[10] It found the conflict "even more troublesome" than the conflict in *In re Project Orange Assocs., LLC*, 431 B.R. 363 (Bankr. S.D.N.Y. 2010), in which the same court did not permit DLA Piper to represent a debtor whose largest unsecured creditor was a General Electric entity, when DLA Piper had represented that entity and continued to represent other GE entities. *Id*. at 236.

Other cases in which joint representation has been denied typically involve actual conflicts, disclosure failures and/or a lack of information. For instance, *In re Granite Partners, L.P*, 219 B.R. 22 (Bankr. S.D.N.Y. 1998) involved improper concealment and failure to disclose conflicts. *In re Jennings*, 199 F. App'x 845, 848 (11th Cir. 2006) affirmed disqualification and denial of any compensation to a law firm found to have "violated Rule 2014 by failing to disclose fully the connections between the firm and its eleven debtor clients." *In re Interwest Bus. Equip., Inc.*, 23 F.3d 311, 314 (10th Cir. 1994) affirmed a bankruptcy court's rejection of a multi-debtor representation at the outset of the cases where potential interdebtor claims had not yet been resolved and where proposed counsel did not provide the court with information about the "validity or amount of intercompany debts." *In re Straughn*, 428 B.R. 618, 625-28 (Bankr. W.D. Pa. 2010) denied motions by both debtors to employ the same counsel where one debtor was a creditor and majority shareholder of the debtor and interdebtor claims had not been resolved. *In re Coal River Res., Inc.*, 321 B.R. 184, 188-89 (W.D. Va. 2005) affirmed the disqualification of a law firm that represented two of four debtors due to intercompany debt that constituted an actual conflict of interest.

The noteholders in *Caesars* argued that K&E's bias toward the equity sponsors was evidenced by the Restructuring Support Agreement and proposed plan, which provided for what the noteholders alleged was a grossly inadequate settlement of the fraudulent transfer claims and afforded broad releases that the noteholders claimed were impermissible. Judge Goldgar ruled that the RSA and plan were not evidence of bias. First, there was no giveaway in the plan, but a facially significant contribution. Second, there was no benefit shown to K&E's other clients, the portfolio companies. Third, "the proposed plan is simply a plan," *i.e*., it was subject to modification.

Concurrent Representation of Parties in Interest – Bidders

In one unique case, a bankruptcy court approved the employment of debtor's counsel that also represented the two bidders for the debtor's assets. *In re Charles Street African Methodist Episcopal Church of Boston*, 2014 WL 1883803 (Bankr. D. Mass., May 9, 2014). In connection with the sale motion, debtor's counsel, disclosed connections with both bidders: (a) the firm represents bidder no. 1 in unrelated matters and is a major donor; (b) a partner is a former chairman of bidder no. 1 and is currently an officer and board member; (c) the firm represents members of the boards of directors of both bidders, and entities affiliates with such members; and (d) a partner is an honorary board member of bidder no. 2. The firm pledged to maintain an

[10] The court also held that conflicts under section 327(a) cannot be waived.

ethical wall to keep the debtor's information confidential from its partner board members, neither of whom would represent the debtor in the case. *Id*. at *3.

The court held that as a matter of practical necessity, the ethical walls would have to suffice, and that since debtor's counsel represented *both* competing bidders, fulfilling its duties to each would maximize the benefit to the estate.

> In a perfect world, the hiring of special conflicts counsel to handle the sale as a discreet matter would be appealing, but it is not practical here. R & G is handling this case pro bono; the estate cannot afford to hire additional counsel. Also, advice on the sale is not easily separable from advice on CSAME's reorganization as a whole, and the history is long and complexities numerous. Conflicts counsel would face a steep learning curve for a relatively simple issue. The dance of coordination and separation between two sets of counsel would be difficult, the choreography more trouble than this issue is worth. R & G is not representing either bidder in this case and is establishing ethical walls to prevent its connections from influencing this process. Lastly, the "appearance" of impropriety is considerably muted by that fact that Ropes has connections not to a single bidder but to two competing bidders, which, if these connections had any influence on the process at all—I find they have not and trust they will not—would be inconsistent with the interests of either bidder but consistent with the maximization of value and the interests of CSAME, the estate, and OneUnited. I see no need for further correctives than those R & G has already undertaken.

Id. at *4.

How many connections are too many? *In re Portrait Corporation of America, Inc*., No. 06-22541 (Bankr. S.D.N.Y.) Debtor's counsel represented numerous creditors, all of which it had agreed not to sue in the bankruptcy case: (1) Wells Fargo Foothill (prepetition lender and DIP lender); (2) Wal-Mart Stores (key licensor); (3) Whippoorwill Associates (bond and trade claim holder and member of creditors' committee; (4) AIG Global Investment (bond holder and committee member; (5) GS Mezzanine Partners II, L.P. (creditor and Goldman affiliate); (6) GS Mezzanine Partners II Offshore, L.P. (same); (7) Travelers Indemnity Company (creditor); (8) Prudential Company (creditor). The U.S. Trustee objected to its retention on the grounds that debtor's counsel represents or has represented virtually every constituency in the case. Debtor's counsel agreed to step down, but moved to be retained as "transitional counsel." The U.S. Trustee objected, arguing in part that debtor's counsel is not disinterested whatever its label and was responsible for and should bear any "transitional costs." The judge granted debtor's counsel motion.

Avoiding Avoidable Payments for Prepetition Services

In re Pillowtex, 304 F.3d 246 (3d Cir. 2002) underscores the risks that attend the payment of prepetition fees. The general rule is that "[a] preferential transfer to [debtor's counsel] would constitute an *actual conflict of interest* between counsel and the debtor, and would require the firm's disqualification." *In re First Jersey Securities, Inc*., 180 F.3d 504, 509 (3d Cir. 1999) (emphasis in original). In *Pillowtex*, the company paid $1 million in fees to its law firm during the 90 day preference period. In its application the firm disclosed the payments. The U.S. Trustee alleged that these payments were preferential and therefore disqualified the firm under the "adverse interest" and "disinterestedness" requirement of 11 U.S.C. § 327.

Debtor's counsel claimed that the payments were not preferential and even if they were, the problem could be cured by agreeing to return the payments in question and waiving its claim. The district court agreed with the latter proposition and approved the employment. The Third Circuit reversed, holding that when there has been a facially plausible claim of a substantial preference, a court "cannot avoid the clear mandate of the statute by the mere expedient of approving retention conditional on a later determination of the preference." *Id*. at 253. The conditions to employment did not satisfy the statute. As to the first condition, that the firm return any amount held to be a preference, the court observed that the firm would be obliged to do so in any event.

Most importantly with respect to the curative measures that a firm can take, the court held that the second condition, the firm's agreement to waive any claim resulting from a preference, was inadequate because such a waiver must be made *prior to seeking approval*.

> Jones Day cites a series of cases to illustrate that a professional can eliminate an adverse interest by waiving any claim it has against the estate, but it is not in the same position as the professionals in these cases. *See, e.g., In re Princeton Medical Mgmt., Inc.,* 249 B.R. 813, 816 (Bkrtcy.M.D.Fla.2000); *In re Fulgham Enters., Inc.,* 181 B.R. 139, 142 (Bkrtcy. N.D.Ala.1995); *In re E. Charter Tours, Inc.,* 167 B.R. 995, 996 (Bkrtcy.M.D.Ga. 1994); *In re Adam Furniture Indus., Inc.,* 158 B.R. 291, 297 (Bkrtcy.S.D.Ga.1993); *In re Watervliet Paper Co., Inc.,* 96 B.R. 768, 774 (Bkrtcy.W.D.Mich.1989).
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> In each of the cited cases, the professional waived its fees *prior* to being approved for retention under section 327(a).

Id. at 253.[11]

Pillowtex teaches that debtor's counsel should not allow accounts receivable to get past due. Payment of a past-due receivable during the preference period is risky, even if made in due course prior to a filing, since it is a payment made on account of antecedent debt. The safest

[11] *Compare In re Enron Corp*., 2003 WL 223455, * 9 (S.D.N.Y. Feb. 2, 2003) (holding that committee counsel was disinterested notwithstanding potential preference because it waived any rights to challenge examiner's findings of a preference).

practice remains to obtain a sufficient pre-petition advance payment retainer before commencing bankruptcy work, and to make sure it is replenished as necessary.

The type of retainer is critical. In *Caesars*, a second objection to K&E's employment was that K&E held an interest adverse to the estate because, in the days immediately after the involuntary petition was filed, it drew $7.2 million for prepetition fees against a retainer that the objectors characterized as a "security retainer." As such, the retainer would have belonged to the debtors on the petition date, making K&E a potential litigation target and creditor (and thus the holder of an adverse interest and non-disinterested). K&E argued that its retainer was an earned-on-receipt "classic retainer" and so was not property of the estate when it was applied to pay its fees.

Illinois law recognizes three types of retainer agreements: (1) a security retainer, which remains the client's property until applied; (2) a classic retainer, paid to secure the lawyer's services; and (3) an advance payment retainer, a hybrid retainer that passes to the lawyer upon payment but is applied to charges for services when rendered. *Id*. at 17. Although K&E's retainer agreement labeled itself a "classic retainer" repeatedly, it called for K&E to issue invoices based on anticipated fees and required the debtors to replenish it upon receipt of invoices. K&E conceded that it was at least in part "an insurance policy against nonpayment" of fees and, in practice, the court found, it was used as the source of payment. "[I]f the retainer was a classic retainer that served only to make Kirkland available to the debtors, there should have been no connection at all between the retainer and any fees the debtors were incurring. In this respect, the engagement letter's use of the word "replenish" was telling. A supply of something (here, money) needs no "replenishing" unless it has been depleted." *Id*. at 19.

In the end, however, the court ruled that even if the retainer was not a classic retainer, it was an advance payment retainer, and either way was not the debtors' property on the petition date. "Like a classic retainer, an advance payment retainer is earned on receipt and does not become property of the client's bankruptcy estate. *Barron*, 432 F.3d at 596; *In re King*, 392 B.R. 62, 71 (Bankr. S.D.N.Y. 2008)." *Id*. at 19.

Notably, the court reached this outcome even though it found that K&E's engagement letter failed to meet the requirements under Illinois law for an advance payment retainer. The law requires that the agreement use that term, that it disclose that the retainer becomes the lawyer's property when paid and that it give the client an option of a security retainer. The K&E agreement only provided that the retainer became K&E's property. The court held, however, that this failure did not transform an advance payment retainer into a security retainer. It was a rule of professional conduct, not a rule of contract interpretation.

In re Dick Cepek, Inc. (Rus, Miliband & Smith, APC v. Yoo), 339 B.R. 730 (9th Cir. BAP 2006) gave relief to debtor's counsel that received a substantial cash retainer immediately prior to the chapter 11 filing, but had no written retainer agreement granting a security interest, and the firm's "statement of disinterestedness" did not disclose any alleged security interest.

The case was administratively insolvent and converted to chapter 7, and the bankruptcy court ordered the firm to disgorge under § 726(b) of the Code in order to equalize the distribution to the other administrative claimants. The BAP reversed in a split decision. Judge Montali's majority opinion, after carefully drawing distinctions between a security retainer, a classic retainer and an advance payment retainer, seemed to fudge the distinction by holding that simple possession of the retainer created a security interest and thus disgorgement was not required.[12] The court also held that while holding a security retainer does not necessarily render a professional not disinterested under section 327, the security interest must be disclosed, and remanded on the issue of adequate disclosure.

Judge Marlar's dissent argued that if the attorney held a security retainer then he is not disinterested under Section 327(a), and chapter 11 counsel should not receive preferred treatment over chapter 7 burial expenses just because he had the leverage to obtain a retainer. "If we endorse the concept espoused by the majority, we will no doubt enjoy immense popularity among bankruptcy professionals -- especially chapter 11 debtors' counsel (the only ones fortunate enough to be able to grab a "secured" retainer before placing the debtor into chapter 11 in the first place). In so doing, however, we do a grave injustice to other bankruptcy professionals who are not so fortunate as to dictate their terms of repayment, including over whom they have priority once the case goes south." *Id*. at 745-66.

Curative Measures – Karmaloop and Claim Waivers

Pillowtex has another important lesson: Merely offering to give up a preference does not cure the conflict.

Judge Walrath's recent decision in *In re Karmaloop Inc.*, Case No. 1:15-bk-10635 (Bankr. D. Del.) provides another example of how <u>not</u> to cure a conflict. The case is worthy of discussion, as it also touches upon imputation, the efficacy of ethical screening, and the use of special counsel to surmount conflicts.

In this two-debtor case, commenced on March 23, 2015, the U.S. Trustee objected to the employment of debtor's counsel's firm on two bases. First, two firm partners (owners of the firm) had been creditors and equity security holders of the debtors, but transferred the interests to family members just prior to the bankruptcy filing. In addition, an associate of the firm is married to the secretary, chief operating officer, general counsel and a director of Karmaloop, Inc., and the secretary, chief operating officer, and a director of KarmaloopTV (all the same person). The associate had been screened from involvement in the case.

Three weeks before the petition date, on March 2, 2015, one of the partners transferred Karmaloop stock, warrants and stock option rights to his brother-in-law, and executed an allonge assigning to his brother-in-law a $150,000 promissory note. On March 17, 2015, the second partner transferred warrants and assigned rights under a $25,000 secured promissory note to her mother. Postpetition, on April 28, 2015, both the brother-in-law and the mother assigned their rights in the various securities and debt instruments to (separate) non-profit corporations.

The U.S. Trustee contended that the firm was not disinterested under section 327(a) of the Bankruptcy Code, arguing that the estates may have preference claims as result of payments on the promissory notes and, therefore, the firm and its owners may have adverse interests that

[12] A Tennessee bankruptcy court reached the same conclusion in another 2006 decision. *In re Appalachian Star Ventures, Inc.*, 2006 WL 1169676 (Bankr. E.D. Tenn. 2006).

would disqualify them under section 327(a) of the Bankruptcy Code. Further, the U.S. Trustee argued that the associate's marriage made her an insider and thus not disinterested, and that her insider status must be imputed to the firm, disqualifying the whole firm. The U.S. Trustee argued that this is the lesson of *In re Essential Therapeutics*, 295 B.R. 203 (Bankr. D. Del. 2003), holding that because one firm member who had served as a corporate officer was not disinterested, the entire firm must be disqualified. Id. at 211 ("We conclude that having one member's independence and disinterestedness impugned because he was an officer must equally affect the firm's independence and disinterestedness such that the firm must be disqualified under Section 327(a) of the Code.). (More on imputation below.)

Debtor's counsel argued that any conflicts on account of the debt and equity interests were cured by the prepetition transfers, and that the associate's insider status should not be imputed to the firm and even if it was, the ethical wall prevented disqualification on that basis.

Judge Walrath ruled on April 30, 2015 that the firm could serve as debtors' counsel for the remainder of the chapter 11 case, but did not approve the employment nunc pro tunc to the petition date. First, the court held that there was no cause to impute a conflict of interest to the firm based on the marriage, since she is an associate, is not working on the Karmaloop case and the firm had screened her from any involvement. This is the positive example of how to cure a conflict. Second, Judge Walrath agreed that the firm's partners were now disinterested by virtue of the transfer of the debt and equity interests to charity. This is the negative example, because the court ruled that the initial transfer of the partners' interests to their family members had not made the partners disinterested, and therefore refused to approve the application nunc pro tunc to the petition date. Judge Walrath stated that "I agree that this has now been cured by the transfer to charity, and will allow retention going forward, but not nunc pro tunc."

The firm had already performed a significant amount of work in the five week period between the petition date and the transfers to charity, primarily in connection with DIP loan negotiations and approval and motions to approve a section 363 sale and bid procedures. In an effort to get paid for this work, the firm filed a motion to be employed as special counsel under section 327(e), nunc pro tunc to the petition date.

Mindful that special counsel cannot be employed under section 327(e) to assist in "conducting the case," the firm proposed that it be employed retroactively to: (a) advise and represent the Debtors in the negotiation and documentation of the DIP financing and court approval of same; (b) advise and represent the Debtors in the transactional, corporate, and corporate finance services required in connection with the proposed sale of substantially all of the Debtors' assets, and any related or alternative transactions; and (c) advise and represent the Debtors with respect to all of their intellectual property matters. The firm offered to waive fees incurred in respect of all other matters.

The 327(e) motion was granted.

Where an attorney actually waives the claim or other interest that creates an adverse interest or precludes disinterestedness (rather than just transferring it to a family member as in *Karmaloop*) the waiver often resolves any conflict arising from the prepetition claim. *See, e.g., In re Metro. Enviro., Inc.*, 293 B.R. 871, 877 (Bankr. N.D. Ohio 2003); *In re Adam Furniture*

Indus., Inc., 158 B.R. 291, 297 (Bankr. S.D. Ga. 1993); *In re Hub Bus. Forms, Inc*., 146 B.R. 315, 321 (Bankr. D. Mass. 1992); *In re Princeton Medical Management, Inc*., 249 B.R. 813 (Bankr. M.D. Fla. 2000) (subordination of claim insufficient); *In re Decor Corp*., 171 B.R. 277 (Bankr. S.D. Ohio 1994) (returning fees paid within preference period). *But see In re TMA Assoc., Ltd*., 129 B.R. 643, 646 n.6 (Bankr. D. Colo. 1991) (claim waiver insufficient).

Notably, *In re Enron Corp. v. Milbank, Tweed, Hadley & McCoy LLP*, 2003 WL 223455 (S.D.N.Y. 2003) held that counsel's agreement to waive its right to challenge any determination of adverse interest with respect to future developments had the same effect as accepted practice of waiving a claim in order to comply with disinterestedness requirement.

Similar measures have been accepted in other contexts as resolving non-disinterestedness status, such as selling shares or resigning from the board of directors or an officer position. *In re Creative Restaurant Management, Inc*., 139 B.R. 902 (Bankr. W.D. Mo. 1992) (attorney resigned officership; disqualification not imputed to firm). *But see Michigan Interstate Ry. Co*., 32 B.R. 327, 329-30 (Bankr. E.D. Mich. 1983) (resignation from office and board and sale of stock postpetition held not to salvage representation); *In re Weibel, Inc*., 161 B.R. 479 (Bankr. N.D. Cal. 1993) (resignation from board prepetition did not prevent disqualification).

Conflicts Counsel and Conflict Waivers

Section 327(e) permits the employment of an attorney that has represented the debtor for a specified purpose other than assisting in conducting the case so long as the attorney does not hold or represent an adverse interest with respect to the matter on which it is to be employed. 11 U.S.C. § 327(e).

The ABI Ethics Report contains a thorough and fairly recent exposition and analysis of the evolving law on using conflicts counsel to address problems with the holding or representation of adverse interests and disinterestedness. ABI Ethics Report at 37-47.

> Although some otherwise disqualifying conflicts can be resolved with conflicts counsel, not all can. The more pervasive a disqualifying conflict is, the less appropriate appointment of the "conflicted out" law firm is. Those conflicts that (1) are unlikely to occur throughout the case, (2) involve just a few parties in interest, (3) do not involve the main issues in the case, and (4) are capable of being handed over to a non-conflicted law firm are more likely to be suitable for the appointment of "conflicts counsel.

Id. at 41. Particularly since section 327(e) is intended to apply to prepetition counsel, the Task Force recommended that separate counsel be employed as co-counsel under section 327(a) where possible, unless the particular conflict is discrete. *Id*. at 39.

The K&E Order in *Caesars* points to conflicts counsel as a means to address any issue concerning K&E's alleged reluctance to take on Apollo and TPG. There is widespread acceptance of this practice as a means of avoiding disqualifying conflicts. *In re Washington Mut., Inc*., 442 B.R. 314 (Bankr. D. Del. 2011) (rejecting confirmation objection based on debtors' counsel's representation of JPMorgan in unrelated matters where conflicts counsel had been retained); *In re Chrysler LLC*, Case No. 09-50002 (Bankr. S.D.N.Y. May 20, 2009); *In re Motors Liquidation Company, et al., f/k/a General Motors Corp., et al*., Case No. 09-50026 (Bankr. S.D.N.Y. Jan. 29, 2010); *In re Adelphia Comm. Corp., supra* (debtors' counsel not disqualified where any actual conflicts may be addressed by conflicts counsel); *In re Enron Corp*., 2003 WL 223455 at *9 (February 3, 2003, S.D.N.Y.) ("This Court concurs with the bankruptcy court that, having found both that Milbank is not involved in any matter in which it has an adverse interest and that the use of conflicts counsel and ethical walls are appropriate, there is no basis for a violation of the Code of Professional Responsibility."); *In re National Century Financial Entertainment, Inc.*, 298 B.R. 112 (Bankr. S.D. Ohio 2003) (law firm represented both creditors' committees and individual creditors; employment approved where separate counsel would be retained for the committees for any matters as to which the interests of the law firm's other clients were adverse to the committees); *Tri-State Fin., LLC v. Lovald*, 525 F.3d 649, 655-56 & n.5 (8th Cir. 2008) (recognizing propriety of using conflicts counsel); *In re Blinder, Robinson & Co*., 131 B.R. 872, 879-81 (D. Colo. 1991) (independent counsel to consider a claim by creditor client rendered SIPA counsel disinterested); *see also In re* eToys, Inc., 331 B.R. 176, 192 (Bankr. D. Del. 2005) (DIP counsel should have promptly filed disclosure affidavit and let another, disinterested professional handle matter involving creditor client).

In *In re Rockaway Bedding, Inc*., 2007 WL 1461319 (Bankr. D.N.J., May 14, 2007) the U.S. Trustee objected to the retention of debtor's counsel who concurrently represented certain prepetition creditors, including the debtor's largest secured creditor, PNC Bank. The court noted the significant harm the debtor would suffer if forced to retain new counsel, and approved a plan to cure potential conflicts through conflicts counsel, a conflicts waiver from PNC Bank, the erection of an ethical wall between professionals providing services to the debtor and to PNC Bank, and debtor's counsel's agreement not to assert any affirmative claims against PNC Bank in connection with Rockaway's bankruptcy proceedings.

As discussed in the ABI Ethics Report, however, when the client presenting the conflict has a large role in the case, or where it is so significant a client that counsel might pull its punches, then even the use of conflicts counsel may not be enough to cure the conflict. In *Project Orange*, for example, the retention of general counsel was denied despite the presence of conflicts counsel to handle issues relating to GE, a major creditor, and despite a limited conflicts waiver from GE in favor of general counsel, where the proposed general counsel represented GE in unrelated matters, the debtor and GE were adverse, and general counsel could not threaten litigation against GE. *In re Project Orange Assoc.,* 431 B.R. 363, 366 (Bankr. S.D.N.Y. 2010); *see also In re Amdura*, 121 B.R. 862, 866-67, 871 (Bankr. D. Colo. 1990) (largest creditor in the case was a significant client of the firm: "the hand that feeds the firm"); *In re Cook*, 223 B.R. 782, 791 (10th Cir. BAP 1998) (hiring conflicts counsel would have been an effective curative measure had it been done at the beginning of the case).

Note that a conflict waiver, standing alone, is generally insufficient to cure a conflict for purposes of employment under section 327(a). "Courts have recognized that conflicts waivers are not effective for purposes of satisfying the "adverse interest" requirement of section 327(a) of the Bankruptcy Code." *In re JMK Construction Group*, 441 B.R. 222, 223 (Bankr. S.D.N.Y. 2010); *In re Project Orange Assoc*., 431 B.R. at 374-75; *In re Envirodyne Indus., Inc*., 150 B.R. 1008, 1016 (Bankr. N.D. Ill. 1993) (section 327(a) "does not allow" the "disinterested persons" requirement "to be excused by waiver"); *In re McGregory*, 340 B.R. 915 (8th Cir. BAP 2006) (inherent and impermissible conflict from representing debtor and acting as mortgage consultant to debtor cannot be waived); *In re Amdura Corp*., 121 B.R. 862, 866 (Bankr. D. Colo. 1990) ("activities and multiple representation that may be acceptable in commercial settings, particularly with the informed consent of clients, may not be acceptable in bankruptcy").

Terminating Adverse Representations

Courts have allowed professionals to overcome disinterestedness concerns as they relate to potential conflicts, provided they take actions to terminate the connection giving rise to the conflict. See, e.g., In re AroChem Corp., 176 F.3d 610, 623-24 (2d Cir. 1999) (under plain terms of section 327(a), firm that withdrew from potentially conflicting representation after its retention by debtor did not hold or represent an adverse interest; "section 327(a) is phrased in the present tense;" "[t]hus, counsel will be disqualified under section 327(a) only if it presently 'hold[s] or represent[s] an interest adverse to the estate'"); TWI Int'l, Inc. v. Vanguard Oil and Serv. Co., 162 B.R. 672, 675 (S.D.N.Y. 1994) (permitting attorney to withdraw from representation of debtor's insider in breach of contract action).

As a matter of state ethics laws, however, attempting to cure a conflict in this manner may be deemed to violate the "Hot Potato Doctrine," under which attorneys cannot drop one client so as to avoid a conflict with another, more remunerative client. Santacroce v. Neff, 134 F.Supp.2d 366, 370 (D.N.J. 2001). Generally, a lawyer cannot rid herself an actual conflict of interest by ridding herself of one of the conflicted clients. Id.; El Camino Resources, Ltd., 623 F. Supp.2d 863 (W.D. Mi. 2007); Merck Eprova Ag v. Prothera, Inc., 670 F.Supp.2d 201 (S.D.N.Y., 2009).

In *In re Lennys Copy Center & More LLC*, No. 13-63108, 2014 Bankr. LEXIS 3138 (Bankr. E.D. Mi. July 18, 2014), a chapter 7 debtor's attorney was disqualified from representing the defendants in a fraudulent transfer action brought by the trustee. The court rejected counsel's proposed solution that he withdraw from representing the chapter 7 debtor, stating that "courts universally hold that a law firm will not be allowed to drop a client in order to resolve a direct conflict of interest, thereby turning a present client into a former client."

Imputation and Ethical Walls

An ethical wall is intrinsic to any proposal for the use special counsel to address conflict issues, as protection against the transmission of confidential information from attorneys employed by the estate to or from attorneys who are not disinterested or who hold or represent adverse interests. *See, e.g.*, *In re Enron Corp*., 2003 WL 223455 at *9 (S.D.N.Y., February 3, 2003) (denying motion to disqualify committee counsel based in part on ethical walls); *In re Caldor, Inc*., 193 B.R. 165 (Bankr. S.D.N.Y. 1996) (approving employment of committee counsel in cases of competing debtors based on use of both special counsel and ethical screening to avoid conflicts of interest).

Certain courts hold that a disabling status or adverse interest must automatically be imputed from an attorney to his or her entire firm. For those courts that impose such a per se rule, the efficacy of ethical walls under state laws or the Model Rules is irrelevant, because it is a matter of federal statutory interpretation.

In re Essential Therapeutics, 295 B.R. 203 (Bankr. D. Del. 2003), a law firm was disqualified where one of its members was an officer and where the firm proposed to establish an ethical wall preventing the conflicted member from receiving any information about the case. Judge Walrath stated: "We conclude that having one member's independence and disinterestedness impugned because he was an officer must equally affect the firm's independence and disinterestedness such that the firm must be disqualified under Section 327(a) of the Code." *Id*. at 211. Because it was a matter of federal law, the court rejected some court's reliance on state law or Model Code of Professional Conduct limiting imputation to circumstances where the individual had an actual conflict of interest. *See, e.g.*, Rules 1.10(a), 1.7, 1.8(c) and 1.9 of the Model Rules of Professional Conduct.

In re Coda Holdings, No. 13-11153 (CSS) (Bankr. D. Del. May 29, 2013). A partner of debtor's counsel's firm was the debtors' former general counsel and senior vice president within two years before the petition date, and thus an insider. The partner waived any claim against or equity interest in the debtors, and the firm had implemented an ethical screen. Nonetheless, the Court found he could not alter his non-disinterested status. Judge Sontchi adopted the *Essential Therapeutics* reasoning, finding disqualification of one historically meant disqualification of the entire firm.

Subsequently, Judge Sontchi approved the employment of the debtor's counsel's firm under section 327(e) *nunc pro tunc* in connection with the sale of assets, DIP financing and general corporate matters, and excluding the plan, disclosure statement, claims, and case administration. (Helpful precedent for B&L in *Karmaloop*).[13]

Other courts have rejected the view that non-disinterestedness must be imputed from individuals to their firms and rejected disqualification, sometimes requiring or approving the implementation of ethical screens.

In *In re Sea Island Company*, No. 10-21034, 2010 WL 4386855 (Bankr. S.D. Ga. 2010), ten attorneys were creditors of the debtor. The court sided with a majority of courts finding that one attorney's disqualification is not imputed to the firm as a whole. It then reviewed the mechanisms for an effective ethical screen, and ruled that unless an attorney waived any claim, the firm must implement an ethical screen providing: (1) the conflicted attorneys may not provide services or bill in connection with the cases; (2) they must be denied access to all files relating to the cases; and (3) there must be no discussion of the cases in their presence. *See also Vergos v. Timber Creek, Inc*., 200 B.R. 624, 629-30 (W.D. Tenn. 1996) (no automatic imputation; one partner's admitted disqualification would not be imputed to the entire firm provided that sufficient screening mechanisms were put in place; "screening devises may be employed [by the debtor's law firm] to guard against any infiltration" of the disqualified

[13] *See also In re Mortgage & Realty Trust*, 195 B.R. 740, 758 (Bankr. C.D. Cal. 1996) (disqualifying entire law firm because lawyer served on debtor's board of trustees at the time of a transaction giving rise to dispute); *In re Capitol Metals Co*., 228 B.R. 724, 727 (9th Cir. BAP 1998) (applying former §101(14)(D) to disqualify debtor's law firm because partner had served as chief financial officer).

lawyer's personal interests"); *In re Chicago South Shore and South Bend R.R.*, 101 B.R. 10, 15 (Bankr. N.D. Ill. 1989) (holding that debtor's law firm had adequately screened lawyer who had previously represented a major creditor); *In re Kaiser Group Int'l, Inc.*, 272 B.R. 846, 852 (Bankr. D. Del. 2002) (creditor waived right to seek disqualification of debtor's counsel by consenting to representation if counsel erected an ethical wall).

In re Cygnus Oil & Gas Corp., No. 07-32417, 2007 WL 1580111, at *3 (Bankr. S.D. Tex. May 29, 2007 (Partner was director, creditor and equity holder of debtor) (disqualification not imputed to firm because the plain language of the Bankruptcy Code is that a person is disqualified, and the person with the conflict was the partner, not the firm. "Courts in other circuits have similarly rejected a per se rule finding that there is no express language in the Bankruptcy Code requiring a firm to be disqualified on the basis of a single non-disinterested member.") (citing cases); *In re S.S. Retail Stores Corp.*, 211 B.R. 699, 703 (9th Cir. BAP 1997) (no per se disqualification based on disinterestedness); *In re Keravision, Inc.*, 273 B.R. 614, 619 (N.D. Cal. 2002) (rejecting argument that law firm was per se disqualified because partner was corporate secretary until three weeks before petition date and authorizing employment of such law firm); *In re Capen Wholesale, Inc.*, 184 B.R. 547, 551 (N.D. Ill. 1995) (former officer position disqualified attorney but not law firm).

Disclosure

"The disclosure requirements of [Fed. R. Bankr. P.] 2014(a) are broader than the rules governing disqualification, and an applicant must disclose all connections regardless of whether they are sufficient to rise to the level of a disqualifying interest under Section 327(a)." *In re Am. Int'l Refinery Inc.*, 676 F.3d 455, 465 (5th Cir. 2012). "Failure to disclose relevant connections is an independent basis for the disallowance of fees or disqualification from the case." *In re Enron Corp., supra*, 2002 WL 32034346, at *5.

An incomplete affidavit under Rule 2014 may not be cured by other filings, held the Eleventh Circuit in *Quarles and Brady v. Maxfield (In re Jennings)*, 2006 WL 2826947 (11th Cir. Oct. 4, 2006). The court of appeal affirmed an order disqualifying previously approved debtor's counsel from representing multiple chapter 11 debtors. In addition to an actual conflict based on one debtor's disregard of another debtor's lien, and two potential intercompany conflicts, the disqualification was based on deficient disclosures. The court of appeal rejected counsel's argument that the missing information was disclosed in other pleadings, stating that "bankruptcy courts are not obliged to hunt around and ferret through thousands of pages in search of the basic disclosures required by Rule 2014." *Id*. at *2.

How much detail is enough? The standards articulated by courts have varied from "all known pertinent facts" to "only those connections … which could reasonably have an effect on the attorney's judgment in the case."[14] In *KLG Gates v. Brown*, 506 B.R. 177 (E.D.N.Y. 2014), the law firm listed 481 creditors who were the law firm's clients on other matters, but did not

[14] *In re Woodcraft Studios Inc.*, 464 B.R. 1, 8 (N.D. Cal. 2011) (stating that duty is one of complete disclosure of all known pertinent facts and professional has no discretion to withhold information); *In re Blue Ridge Limousine and Tour Serv. Inc.*, 2014 WL 4101595, 5 (Bankr. E.D. Va. Aug. 20, 2014) (calling for "common-sense analysis"). *See generally* Paul M. Nussbaum and Susan Jaffe Roberts, *Prevent Disqualification and Disgorgement: Disclosure is Key*, ABI Journal, Vol. XXXIV, No. 1, January 2015.

provide any detail about potential conflicts. The district court found the disclosure deficient with respect to creditors PNC Bank and Wilmington Trust, in part because the firm did not disclose which individual attorneys were involved in those representations. *Id*. at 193-94. It did hold, however, that the firm did not need to disclose its attorneys' past relationships with an attorney for certain insiders or with firm-selected independent director. *Id*. at 195. It remanded the matter to the bankruptcy court to determine whether the law firm should be disqualified.[15]

In re SonicBlue, Inc., et al., Case No. 03-51775 (Bankr. N.D. Cal.) also dealt with inadequate disclosure. In its initial disclosure of disinterestedness and subsequent supplemental disclosures, debtors' counsel did not disclose its connection with the senior bondholders. The firm had represented the debtor in numerous pre-petition matters, one of which was a note issuance. The firm provided an opinion letter lacking a bankruptcy exception. The investors threatened to sue the firm if they failed to recover all of their $75 million investment. The firm failed to notify the court of the original transaction or the investors' threat. Nor did committee counsel, when it learned of the conflict. The firm formally disclosed the opinion letter only after the bondholders demanded indemnification from counsel and the trustee sought to disqualify counsel. The bankruptcy court held that disqualification of the debtors' counsel and appointment of a chapter 11 trustee were warranted. It was clear that counsel knew it had a continuing duty to update its disclosures and knew that it had a disabling conflict of interest, and counsel's characterization of the failure to disclose as an inadvertent oversight was belied by counsel's history of supplemental disclosures. "In the end, … whether intentional or inadvertent, (Pillsbury's) failure to disclose this significant and disabling conflict in any reasonable fashion mandates immediate disqualification of (Pillsbury) from its representation in this case." *In re Sonicblue, Inc*., 2007 WL 926871, at *15 (Bankr. N.D. Cal. Mar. 26, 2007).

After a trustee was appointed, the trustee further uncovered that the debtor's counsel's firm had failed to disclose or return $1.3 million in preferential payments that it received for its services in the months prior to bankruptcy, which would have required disqualification under *Pillowtex*. Further, the trustee charged that committee counsel persuaded the committee not to pursue recovery from the firm despite there being no defense to the claims. *See In re SonicBlue Inc*., 422 B.R. 204, 212 (Bankr. N.D. Cal. 2009) (describing case history in context of order on substantial contribution claim). In the end, settlements were reached in which the firm remitted or waived $10 million in fees, including the preference liability, and committee counsel remitted or waived $2.5 million.

In re Congoleum Corp., 426 F.3d 675 (3d Cir. 2005) held that the bankruptcy court should not have approved the retention of special insurance counsel because the firm had acted as counsel for the debtor prepetition in negotiating settlements with asbestos claimants represented by attorneys who were co-counsel with the firm in insurance matters for those same claimants. The firm had an actual conflict because of the duties it owed the individual claimants it represented as co-counsel prepetition, and also because of its ownership interest in the entity that would be administering the claims process. The court of appeal held that given the many hats that the firm had been wearing, it could not conclude that the claimants had given informed

[15] *See* Joseph J. McMahon, Jr., *Naming Names After Brown: Is There an Obligation under Rule 2014(a) to Identify Attorneys Who Staff Unrelated Creditor Representations?*, XXXIII ABI Journal 5, 42-43, 108, May 2014.

consent for the conflicting representations. On remand, the bankruptcy court ordered the firm to forfeit $13 million in fees. *In re Congoleum Corp.*, 03-51524 (D.N.J. Feb. 7, 2006).

In re Hutch Holdings, Inc., 2015 WL 1543255 (S.D. Ga. March 31, 2015). In a recent decision involving Rule 2014 disclosure requirements, proposed debtor's counsel was held to have violated Bankruptcy Rule 2014 by not disclosing certain relationships, including the fact that it represented the 100% shareholder of the debtor in his own bankruptcy. The U.S. Trustee objected. The court found that the undisclosed relationships did not warrant disqualification, but that the law firm's habitual failure to comply with Rule 2014 in this and other cases warranted sanctions.

In re GSC Group, Inc., 502 B.R. 673 (Bankr. S.D.N.Y. 2013). The U.S. Trustee sought to disqualify debtor's counsel and the financial advisor for failing to disclose necessary relationships, including a prohibited fee-sharing arrangement between the financial advisor and an independent contractor (the CRO provided by the financial advisor was actually an independent contractor with a consulting agreement and the financial advisor retained a portion of his fees). The law firm assisted the consultant with the creation of two business entities and represented those entities in two unrelated cases. The firm was also charged by U.S. Trustee with responsibility for its role in preparing employment application and declaration for the financial advisor that were inaccurate, notwithstanding its argument that it relied on the financial advisor for information. Ultimately, the law firm settled by remitting/waiving $1.5 million. The financial advisor went to trial, and the court held that while its arrangement with CRO did not violate section 504(b)'s proscription on fee-sharing, the failure to disclose it violated Rule 2016; the court docked the financial advisor $967,000 for the violations, stating that "Capstone's attitude toward its duty of disclosure falls somewhere on the continuum between lackadaisical and arrogant." *Id*. at 737-38.

In re eToys, Inc., 331 B.R. 176 (Bankr. D. Del. 2005), involved multiple disclosure failures, resulting in the voluntary disgorgement of $750,000. eToys had retained an individual to coordinate the liquidation, then as CEO, then as Plan Administrator, and Committee counsel failed to disclose its longstanding relationship with that individual and the fact that the law firm was partners with the individual in an entity called Asset Disposition Advisors, and had paid the individual $30,000/month for several months until his retention in the case. The firm had recommended the individual to the debtor. The firm also failed to disclose a material connection with the lender. Debtor's counsel had failed to disclose its representation of GECC and two Goldman affiliates in a bankruptcy case filed by Finova Capital on the same day.

Committee counsel agreed with the UST to disgorge $750,000, half its postpetition, preconfirmation compensation. In October 2005, Judge Walrath issued an opinion approving the settlement with the committee counsel, and requiring the Debtor's counsel's firm to disgorge all fees paid to it for work concerning Goldman during the five months of the case before it disclosed that conflict, and for work concerning GECC in the first two months of the case before it disclosed that conflict. The court agreed with the individual that officers do not need to be employed under Section 327(a), but noted it had the power to review and deny officer compensation, and must have complete disclosure by officers of any relationships with the major participants in the case in order to exercise that power. Accordingly, Judge Walrath articulated a new disclosure rule: "In the future, … the failure of an officer of a debtor to disclose such relationships will subject that officer to review and possible disgorgement of compensation if the Court concludes that the relationship constitutes an actual conflict of interest."

In re Balco Equities Ltd., Inc., 345 B.R. 87 (Bankr. S.D.N.Y. 2006) (Law firm's admitted failure to adequately disclose its connections with parties in interest, including representations of the debtors' principal and a large secured creditor), which failures enabled its employment, warranted denial of all fees to firm, particularly given that failure to disclose was deliberate). The firm sought to place the blame for the lack of disclosures on a former associate to which it had entrusted the 'procedural details,' a defense that the court rejected summarily.

Other notable cases include *In re Jackson*, No. 06-36268 (Bankr. S.D. Tex. Dec. 5, 2012) (failure to conduct an adequate conflicts check); *In re Jore Corp*., 298 B.R. 703 (D. Mont. 2003). (D. Mont. 2003) (failure to disclose that conflict waiver from creditor client had "no litigation" exception); *Geisenberger v. DeAn*gelis, 2011 U.S. Dist. Lexis 108916 (M.D. Pa. Sept. 23, 2011) (failure to disclose connections to creditors and involvement in debtor's stock offerings); and *In re Universal Building Products*, 486 B.R. 650 (Bankr. D. Del. 2010) (proposed counsel for the committee solicited committee votes through translator. The court explained that the solicitation communications were relevant "connections" and noted that the lawyers' failure to disclose such connections was enough to require disqualification of counsel from committee employment).