The Ethics of Getting Hired

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Topic: Imputed Disqualification

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Cases on Imputed Disqualification

1. Statutory and Rule Provisions and Selected Cases on §327(e)

11 U.S.C. §327(a)

Except as otherwise provided in this section, the [debtor], with the court's approval, may employ one or more attorneys . . .or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the [debtor] in carrying out the [debtor's] duties under this title.

11 U.S.C. §327(e)

The Trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that is represented the debtor, if in the best interest of the estate, and if 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.

Rule 2014. Employment of Professional Persons

(a) Application for an order of employment

* * *

The application shall state . . . all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. The application shall be accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.

(b) Services rendered by member or associate of firm of attorneys or accountants

If, under the Code and this rule, a law partnership or corporation is employed as an attorney, or an accounting partnership or corporation is employed as an accountant, or if a named attorney or accountant is employed, *any partner, member, or regular associate of the partnership, corporation or individual may act as attorney or accountant so employed*, without further order of the court.

Rule 5002. Restrictions on Approval of Appointments

(a) Approval of appointment of relatives prohibited
The appointment of an individual as a trustee or examiner pursuant to § 1104 of the Code shall not be approved by the court if the individual is a relative of the bankruptcy judge

approving the appointment or the United States trustee in the region in which the case is pending. The employment of an individual as an attorney, accountant, appraiser, auctioneer, or other professional person pursuant to §§ 327, 1103, or 1114 shall not be approved by the court if the individual is a relative of the bankruptcy judge approving the employment. The employment of an individual as attorney, accountant, appraiser, auctioneer, or other professional person pursuant to §§ 327, 1103, or 1114 may be approved by the court if the individual is a relative of the United States trustee in the region in which the case is pending, unless the court finds that the relationship with the United States trustee renders the employment improper under the circumstances of the case. *Whenever under this subdivision an individual may not be approved for appointment or employment, the individual's firm, partnership, corporation, or any other form of business association or relationship, and all members, associates and professional employees thereof also may not be approved for appointment or employment.*

(b) Judicial determination that approval of appointment or employment is improper
A bankruptcy judge may not approve the appointment of a person as a trustee or examiner pursuant to § 1104 of the Code or approve the employment of a person as an attorney, accountant, appraiser, auctioneer, or other professional person pursuant to §§ 327, 1103, or 1114 of the Code if that person is or has been so connected with such judge or the United States trustee as to render the appointment or employment improper.

Definitions

a. "Interest adverse": not defined by Bankruptcy Code.
b. "Disinterested person": one "who is not a creditor . . .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 debtors, or for any reason." 11 U.S.C. §101(14).
c. "Insider": "if the debtor is a corporation… (VI) relative of a general partner, director, officer, or person in control of the debtor." 11 U.S.C. §101(31)(B)(vi).
d. "Relative": "individual related by affinity or consanguinity within the third degree as determined by common law." 11 U.S.C. §101(45).
e. "Consanguinity" refers to blood relationships.
f. "Affinity": "the relationship enjoyed between one spouse and the blood relatives of the other spouse. Each spouse is related by affinity to the blood relatives of the other in the same degree the others related to them by blood. *In re Busconi*, 177 B.R. 153 (Bankr. D. Mass. 1995)

Selected Cases on §327(e)

a. The "special purpose to be served by counsel appointed under section 327(e) must not be related to the debtor's reorganization since this is tantamount to representing the debtor in the conduct of the case." *In re Tidewater Mem. Hosp., Inc*., 110 B.R. 221, 228 (Bankr. E.D. Va. 1989).

b. In considering whether to appoint special counsel, a court "may look at the totality of the circumstances, including the role of counsel prior to the filing and the actual services performed . . ." *In re J.S. II, L.L.C.*, 371 B.R.311, 318 (Bankr. N.D. Ill.2007)

Model Rules of Professional Conduct
Client-Lawyer Relationship
Rule 1.10 Imputation Of Conflicts Of Interest: General Rule

(a) While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by Rules 1.7 or 1.9, unless

b. (1) the prohibition is based on a personal interest of the disqualified lawyer and does not present a significant risk of materially limiting the representation of the client by the remaining lawyers in the firm; or

c. (2) the prohibition is based upon Rule 1.9(a) or (b) and arises out of the disqualified lawyer's association with a prior firm, and

d. (i) the disqualified lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom;

e. (ii) written notice is promptly given to any affected former client to enable the former client to ascertain compliance with the provisions of this Rule, which shall include a description of the screening procedures employed; a statement of the firm's and of the screened lawyer's compliance with these Rules; a statement that review may be available before a tribunal; and an agreement by the firm to respond promptly to any written inquiries or objections by the former client about the screening procedures; and

f. (iii) certifications of compliance with these Rules and with the screening procedures are provided to the former client by the screened lawyer and by a partner of the firm, at reasonable intervals upon the former client's written request and upon termination of the screening procedures.

g. (b) When a lawyer has terminated an association with a firm, the firm is not prohibited from thereafter representing a person with interests materially adverse to those of a client represented by the formerly associated lawyer and not currently represented by the firm, unless:

h. (1) the matter is the same or substantially related to that in which the formerly associated lawyer represented the client; and

i. (2) any lawyer remaining in the firm has information protected by Rules 1.6 and 1.9(c) that is material to the matter.

j. (c) A disqualification prescribed by this rule may be waived by the affected client under the conditions stated in Rule 1.7.

k. (d) The disqualification of lawyers associated in a firm with former or current government lawyers is governed by Rule 1.11.

2. ***In re Essential Therapeutics, Inc.*, 295 B.R. 203 (Bankr. D. Del. 2003)**

A Bingham McCutcheon partner, Mr. Julio Vega, served as Secretary of Essential Therapeutics (the "Debtor") within two years of Essential Therapeutics' bankruptcy filing. *Essential Therapeutics* at 305. Essential Therapeutics made its chapter 11 filing on May 1, 2003 and filed an application to retain Bingham under sections 327 and 331 on May 2, 2003. *Id*. The UST objected to the Debtor's application, and Judge Walrath ruled on that objection after a hearing on May 20, 2003. *Id*.

Judge Walrath began her inquiry by turning to the language of section 327. She noted that the statute requires an attorney representing a debtor to be a "disinterested person," which is a term that 11 U.S.C. §101(14) defines. *See Essential Therapeutics* at 205. Under that section, a "disinterested person" is a "person that ... (D) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor." 11 U.S.C. § 101(14). The Debtor argued that although Mr. Vega served as Secretary of the Debtor within two years of the filing, Bingham should not be disqualified because Mr. Vega's directorial role was simply ministerial, and therefore did not fulfill the definition of "officer" under the statute. *See Essential Therapeutics* at 206. In response, the UST argued that the statute was not ambiguous, and that the legislature clearly intended to include someone like Mr. Vega under the exclusion that it announced in section 101(14). *See id.*

The court agreed with the legal analysis of the UST with regard to the intersection of section 101(14) and section 327. *See id*. Since the Debtor's bylaws provide that the Secretary is one of the Debtor's officers, Judge Walrath reasoned, section 101(14) precluded the Debtor from retaining Mr. Vega. *See id.* at 206–07.

Additionally, the court found that section 1107(b) did not apply. Section 1107(b) prohibits disqualification under section 327 solely on the basis of prior employment by or representation of the debtor. *See* 11 U.S.C. § 1107(b); *Essential Therapeutics* at 207. Judge Walrath construed § 1107(b) narrowly to mean that the section prohibited disqualification *solely* on the basis of prior employment or representation. *See Essential Therapeutics* at 207–08.

Finally, Judge Walrath imputed Mr. Vega's disqualification to the entire Bingham firm. *Id.* at 211. Judge Walrath based her decision on two specific reasons. First, disqualification of Bingham was necessary because interrogating each Bingham attorney to assure Mr. Vega did not influence them would be a "herculean task." *See id*. at 210. Second, Congress enacted section 101(14) out of the belief that service by a firm attorney as an officer within two years of a debtor's bankruptcy filing would affect the "essential character of independence and disinterestedness which is required of counsel for the estate." *See id.* Judge Walrath found that a fundamental conflict of interest could exist if Mr. Vega had to answer questions posed by his Bingham colleagues as to his involvement in Essential Therapeutics' failure. *See id*. at 210–11.

Cases Following Essential Therapeutics

Other courts have followed Judge Walrath's reasoning on the imputed disqualification issue. *See In re Moon Thai & Japanese, Inc.*, 2010 WL 3211981, *1, *2, n. 16 (Bankr. S.D. Fla. Aug. 11, 2010); *In re McEver*, 2008 WL 416932, *1, *2 (Bankr. M.D. Ga. Feb. 12, 2008).

Cygnus Oil: A Different Approach

The court in *In re Cygnus Oil and Gas Corp.*, 2007 WL 1580111, *1, *2–3 (Bankr. S.D. Tex. May 29, 2007) explicitly disagreed with *Essential Therapeutics'* imputed disqualification holding. The court ruled that the language of section 101(14) did not require imputed disqualification. Additionally, the court disagreed with Judge Walrath's conclusion that the actions of one attorney necessarily would affect the partiality of his partners and associates. *See id.* at *3. The court applied a "materially adverse" test to determine whether the indirect relationship of one partner to the debtor (here, by formerly holding an interest in the debtor) disqualified an entire firm from serving as counsel to the debtor. *See id.* at *3–*4. The court determined that the indirect interest in this case was not materially adverse to the debtor, and accordingly decided not to disqualify the firm from representing the debtor. *See id.* at 4.

3. ***In re Karmaloop, Inc., et al.*** **Chapter 11 Case No. 15-10635 (MFW) (Bankr. D. Del. 2015) (Walwrath, J.); summary of Burns & Levinson employment application**

Burns & Levinson had represented Karmaloop, et al. for several years before the bankruptcy filing date, and represented Karmaloop in filing its chapter 11 case on March 23, 2015 (the Petition Date"). On April 2, 2015, the (the "Debtors") filed a retention application seeking to employ B&L as counsel under §327(a). The Debtors simultaneously filed an application (which was subsequently granted) to employ the firm of Womble Carlyle to be B&L's co-counsel to the Debtors. B&L's retention papers disclosed the following relationships:

a. Two partners of B&L held notes and nominal equity interests in the Debtors. One of those partners had served as an administrative agent for one of the noteholder groups. Prior to the Petition Date, the partners transferred their note and equity interests. (The identity of the transferees was not noted in the B&L declaration.)

b. An associate at B&L was the wife of the Debtors' chief operating officer, general counsel, and secretary. He was also a director. The associate was not involved in representing the s in connection with their bankruptcy case. Further, B&L erected a screen that separated the associate from any involvement with the cases.

In communications with the U.S. Trustee after the retention papers had been filed, B&L disclosed that the pre-petition transferees of the notes and interests were relatives of the B&L partners. In one case, the transferee was the partner's brother-in-law (his wife's brother); in the other, the transferee was the partner's mother.

On April 27, 205, the U.S. Trustee objected [DE 232] to the employment application on the ground that the relationships made B&L not disinterested and made B&L the holder of interests adverse to the bankruptcy estates. The UST argued that B&L partners' transfer of their interests did not solve the disinterestedness problem *because the transfers were to relatives*. The UST noted that the notes and interests were still "within [the partners] families." Moreover, relying on Judge Walrath's decision in *In re Essential Therapeutics*, 295 B.R. 203 (Bankr. D. Del. 2003), the UST asserted that the B&L associate who was married to the officer and director of the Debtors was an insider of the debtors who lacked disinterestedness, and that her lack of disinterestedness was imputed to the entire firm.

In a supplemental declaration filed on April 30, 2015 [DE 178], B&L informed the court that on April 27, 2015, the transferee relatives of the two partners had donated the notes and interests to charity. Also, after the filing date, the Debtors' officer and director who was married to the B&L associate resigned all of his positions with the debtors.

At a hearing on April 30, Judge Walrath ruled that the marital relationship between the B&L associate and the Debtors' officer did not cause B&L to fail the §327(a) disinterestedness requirement. (Transcript at 47-48.[1]) The key to her ruling was that the associate had not worked on the case. She would have disqualified B&L if the associate had worked on the case. *Id.* Judge Walrath arrived at the opposite conclusion regarding the two partners. After noting that B&L had not initially disclosed that the transfers were to relatives, she stated

> I agree we can't have a per se rule of indication [sic][2] of a conflict of interest from an attorney to the firm[3]. . . . I am not convinced that transfer of such interests to relatives makes those partners no longer interested. And I do believe that because they were partners in the firm, their disqualification is imputed to the firm. But I agree with the debtor, that has now been cured by the transfer of those interests outside of their control to charities. So I would allow the debtor to retain them going forward from the time the interests were transferred [from the relatives to the charities]. But I would not allow it on a *nunc pro tunc* basis.

Tr. at 46 – 47.

Accordingly, on May 7, 2015, the Court entered an order approving the retention of B&L as §327(a) counsel *nunc pro tunc* only to April 27 -- the date on which the B&L partner's interests were conveyed to charities.

At the hearing, before the judge had ruled, B&L asked the Judge to consider the B&L employment application as one for special counsel under §327(e) from the petition date to the date that the partners relatives transferred the notes and interests to charities, and then "converting" to plenary counsel under §327(a) from the transfer date forward. B &L reasoned that proceeding under §327(e) would allow it to avoid the disinterestedness requirement. B&L made clear that under this approach, it would not seek compensation for services customarily rendered by plenary Chapter 11 counsel. The Judge declined that invitation. After the judge had ruled, B&L asked for "straight" §327(e) treatment from the Petition Date forward, without a "changeover" to §327(a). Judge Walrath declined to rule on that issue because she determined it was not properly before her.

On May 7, B&L filed an application under §327(e) to be employed as special counsel, nunc pro tunc during the "gap" period between the Petition Date and the date on which the court determined B&L had satisfied the requirements for employment under §327(a) -- April 27. The

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[1] The Hearing transcript is at DE 232-1.

[2] Although the transcript uses the word "indication," it appears that the Judge used, or intended to use, the term "imputation."

[3] Referring to her decision in the *Essential Therapeutics* case, Judge Walrath said "I am happy to learn from my mistakes."

UST again objected. On May 28, the court overruled the UST's objection and granted B&L's §327(e) application.

In summary, the court entered orders approving B&L as §327(e) special counsel from the Petition Date through April 27, and as §327(a) plenary counsel (along with co-counsel Womble Carlyle) from April 27 forward.

4. ***In re Reed and Barton Corp.,*** **Chapter 11 Case No. 15-10534 (MFW) (Bankr. D. Mass. 2015) (Boroff, J.); summary of Holland & Knight employment application**

Holland & Knight had represented Reed and Barton (the "Debtor") for at least 15 years prior to the filing date, and represented Reed and Barton in filing its chapter 11 case on February 17, 2015. The Debtor filed a retention application [Doc 3] on the same date. The application sought to employ H&K as counsel pursuant to § 327(a). An affidavit attached to the retention application disclosed the following relationship:

a. [T]he Disclosure Procedures indicate that a partner of H&K, Richard M. Yanofsky ("Yanofsky"), served as the Secretary of the Debtor from April 29, 1998 to January 15, 2015. As the Secretary of the Debtor, Yanofsky fulfilled only a ministerial role, and did not control the actions of the Debtor in any way. Yanofsky was not compensated for his service as Secretary and although H&K was compensated for legal services rendered during that time period, and has never owned any equity in the Debtor.

H&K decided to implement an ethical wall with respect to Yanofsky and the Debtor's chapter 11 case. The affidavit attached to the retention application stated that Yanofsky would not be involved with H&K's representation of Reed and Barton in connection with the chapter 11 case.

The U.S. Trustee objected to the retention application [Doc 90] on March 12, 2015. The UST based his objection on two grounds. First, he argued that because Mr. Yanofsky served as secretary of the Debtor within two years of the petition date, the plain language of 11 U.S.C. §§ 101(14)(B) and 327(a) deemed both Yanofsky and H&K not disinterested, and therefore not qualified to serve as bankruptcy counsel. Second, he noted that the retention application and accompanying affidavit did not contain sufficient information as to how and when H&K received payments totaling as much as $725,000 from the Debtor for services rendered during the year prior to the petition date. Lacking this information, the UST argued, it was impossible to determine whether H&K was a creditor and/or received preferential transfers that would disqualify it from serving as bankruptcy counsel under 11 U.S.C. §§101(14)(A) and (C), 327(a), 547(b), 502(d) and 550(a)(1).

The Debtor filed a response to the UST's objection [Doc 105] on April 16 in advance of an April 18 hearing before Judge Boroff to decide the issue of H&K's retention. The Debtor claimed that H&N, and not Yanofsky, was the statutory "person" whose disinterestedness was relevant to the Section 327(a) inquiry. To substantiate this claim, the Debtor cited two cases (*In re Cygnus Oil and Gas Corp.*, 2007 WL 1580111 at *3 (Bankr. S.D. Tex. May 29, 2007) and *In re Sea Island Co.*, 2010 WL 4386855 at *2 (Bankr. S.D. Ga. Oct. 20, 2010) holding that if attorneys within a firm either held stock in a debtor, served as a directors of a debtor pre-petition,

or were personal creditors of the debtor, then their firms still could be "disinterested persons" under § 101(14). Additionally, the Debtor cited two cases (*In re Keravision, Inc.*, 273 B.R. 614, 616 (N.D. Cal. 2002) and *In re Creative Rest. Mgmt., Inc.*, 139 B.R. 902, 912 (Bankr. W.D. Mo. 1992)) for the proposition that an attorney's disqualifying role as assistant secretary or other officer of a debtor did not disqualify the entire firm.

The Debtor also pointed to the absence of any statutory language requiring imputed disqualification. Furthermore, "when imputation is intended, as in Fed. R. Bankr. P. 5002(a), it is express, and when imputation is not intended, as in Rule 5002 (b) it is simply omitted – – an omission that is evident in a review of Rule 2014 relating to employment of counsel."[4]

Following a hearing on the UST's objection that the court held on March 18, 2015, Judge Boroff issued an order [Doc 132] authorizing the Debtor to employ and retain H&K as its counsel pursuant to Section 327(a) *nunc pro tunc* to the petition date. The order stated Judge Boroff's conclusions "that H&K and its partners, counsel, and associates do not hold or represent any interest adverse to the interests of the Debtor's estate and that H&K is a 'disinterested' person as that term is defined under section 101(14) of the Bankruptcy Code; and [that] the Court . . . determined that H&K's representation of the Debtor is permissible under sections 327 and 330 of the Bankruptcy Code." The order did not contain the reasoning that Judge Boroff used to reach those conclusions.

[4] Debtor's response to Trustee's Objection to Application to Retain Holland & Knight LLP at 2.