CONFLICTS OF INTEREST: HOW DOES IT AFFECT WORKING FOR A U.S. BANKRUPTCY ESTATE?

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"CAN PROFESIONALS ETHICALLY WORK FOR A U.S. BANKRUPTCY ESTATE WHEN THEY HAVE CONFLICTS OF INTEREST? IS THERE A FIX?"

I. Introduction

- The United States Bankruptcy Code imposes significant restrictions on professionals that are employed or compensated by the estate. In general, these restrictions prevent professionals from representing interests that are adverse to the estate.
- The fundamental goals of these restrictions are to (i) ensure undivided loyalty and (ii) preserve public confidence in the fairness of the bankruptcy system.
- As bankruptcy cases have become larger and more complex, the ethical restrictions imposed on bankruptcy professionals have moved to the forefront of bankruptcy practice.
- The use of conflicts counsel to deal with matters for which general bankruptcy counsel is conflicted has become common.
- There has been a recent flurry of objections to retention applications and fee applications, on the basis of the "disinterested" and "adverse interest" requirements of Bankruptcy Code Section 327. These objections demonstrate the increased attention being given to ethical issues with regard to the retention of professionals.
    - Debtor's Accountant: Disqualification motion and request for disgorgement of KPMG's fees in Worldcom;
    - Debtor's Counsel: Objection to the retention of Paul Weiss in Garden Ridge;
    - Debtor's Counsel: Objection to, and the ensuing court refusal to allow the retention of Skadden, Arps as 327(a) counsel in Genuity; and
    - Debtor's Counsel: Objection to retention of Kirkland & Ellis in Chemtura Corp. and General Growth Properties.
- This outline addresses the standards imposed by the Bankruptcy Code on professionals employed by debtors or trustees in U.S. Chapter 11 cases:
    - Distinction between general bankruptcy counsel and special purpose counsel;

- Standards imposed on debtor's professionals under the Bankruptcy Code, including the disinterestedness and adverse interest standards, as well as counsel's fiduciary duties;
- Frequent examples of situations in which courts determine that professionals are disinterested or hold adverse interests;
- Attempts to cure conflict situations;
- Consequences of being disinterested or holding an adverse interest;
- Duty of disclosure to court and creditors; and
- Consequences of a professional's failure to adequately disclose all connections.

- This outline does not address ethical rules under state law, which also apply in a bankruptcy context.

II. Procedural Framework

A. The retention of a professional must be approved by an order of the court.

1. Persons to be retained by debtor under Sections 327(a) or 327(e) of the Bankruptcy Code must receive bankruptcy court approval and the entry of a retention order.

   - Section 327 applies to professionals employed by a trustee or debtor in possession under chapter 11, but does not apply to professionals employed by a debtor under chapter 7 or chapter 13 or a debtor under chapter 11 that is not a debtor in possession. See, e.g., In re Tirado, 329 B.R. 244 (Bankr. E.D. Wis. 2005) (section 327 does not apply to retention of professionals in a Chapter 13 case); In re Gutierrez, 309 B.R. 488 (Bankr. W.D. Texas 2004) (same).

2. Debtors frequently provide drafts of retention-related pleadings to the U.S. Trustee for review prior to filing:

   - Draft applications, affidavits and orders;
   - Conflict waiver letters; and
   - Supplemental affidavits.

3. Pleadings must be filed and served on U.S. Trustee and certain creditors pursuant to standard or special notice lists:

   - Application (see Bankruptcy Rule 2014(a));
   - Verified statement of person to be employed (see Bankruptcy Rule 2014(a)); and

- Proposed order.

4. *Nunc pro tunc* retention may be available in "extraordinary" circumstances. See In re Keren Ltd., P'ship, 189 F.3d 86 (2d Cir. 1999); In re Tricycle Enter., Inc., 2007 WL 1814447 (Bankr. N.D.N.Y. June 21, 2007) (denying application to retain special counsel to chapter 11 debtor *nunc pro tunc* to petition date). Depending on the jurisdiction, the court may require the moving party to demonstrate that:

    - Failure to file timely application was due to excusable neglect or, alternatively, extraordinary circumstances;
    - Estate has benefited from services already performed; and
    - Application would have been approved initially.

5. Pursuant to the 2007 amendments to the Bankruptcy Rules, new Rule 6003 prohibits the Court from granting applications to employ professionals during the first 20 days of the case except to the extent necessary to avoid immediate and irreparable harm.

    - Based on Rule 6003's 20-day notice requirement, retention applications are frequently filed on the first day of the case with a hearing on interim and final approval upon at least 20 days notice.

B. Compensation

1. Interim Fee Applications

    (a) Amounts awarded in interim fee applications remain subject to disgorgement. See 11 U.S.C. § 330(a)(5); In re Kendavis Indus. Int'l, Inc., 91 B.R. 742, 746 (Bankr. N.D. Tex. 1988) ("[F]ees awarded prior to the end of the case are by definition interim, and may be reviewed by the Court at the close of the case.").

2. Final Fee Application

    (a) All fees previously allowed on an interim basis are nonetheless again subject to a final review.

    (b) Even fees approved on a final basis are subject to disgorgement due to a failure to disclose pertinent information or in the event a conflict becomes known to the court. See R&R Assocs. of Hampton, No. 91-10983-MWW, 2003 WL 1233047 (Bankr. D.N.H. 2003) (*vacated on other grounds*, 2003 WL 21434911 (D.N.H. June 20, 2003).

C. Parties that frequently challenge or object to fees:

1. U.S. Trustee;

2. Creditors' Committee;

3. Individual creditor (usually in response to adverse action against creditor);

4. Chapter 11 or 7 Trustee; and

5. Court, *sua sponte*.

III. Distinction Between General Counsel and Special Counsel

A. General Bankruptcy Counsel

1. Section 327(a) permits the debtor in possession to employ attorneys, accountants and other professionals, provided that they:

(a) Do not hold or represent an interest adverse to the estate; and

(b) Are disinterested persons.

2. 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 in the event that they satisfy the requirements of Section 327.

B. Special Purpose Counsel

1. 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) 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.

See, In re Woodworkers Warehouse, Inc., 323 B.R. 403 (D. Del 2005).

2. Counsel retained for a specific purpose (and not general bankruptcy counsel) pursuant to Section 327(e) is subject to a less rigid standard because the bar against holding or representing adverse

interests applies only to the specific matter for which the debtor seeks to employ the attorney.

- But see In re Congoleum Corp., 426 F.3d 675 (3d Cir. 2005) (reversing lower courts' approval of retention of special insurance counsel based, in part, on improper application of Section 327(e) rather than Section 327(a) given expansive nature of firm's assignment); In re Running Horse, LLC, 371 B.R. 446 (Bankr. E.D. Cal. 2007) (denying employment application under Section 327(e) because debtor did not seek to employ law firm for a "specified special purpose" that was sufficiently unrelated to reorganization case); In re First Am. Health Care of Georgia, Inc., No. 96-20188, 1996 WL 33404562, at *4 (Bankr. S.D. Ga. Apr. 18, 1996) (limiting range of services to be provided by counsel under Section 327(e) and holding that Section 327(e) "must be narrowly construed to avoid evisceration of the general rule"); see also In re Abrass, 250 B.R. 432 (Bankr. M.D. Fla. 2000) (denying employment application under Section 327(e) because law firm sought employment to provide general representation services).

3. Section 327(e) does not specifically authorize the retention of non-attorneys for special purposes.

   - In re Andover Togs, Inc., 96-Civ-7601, 2001 WL 262605 (S.D.N.Y. Mar. 15, 2001) (reversing bankruptcy court and ruling that § 327(e) does not apply to accountants).

   - Nevertheless, in some circumstances, courts have approved the retention of non-attorneys for special purposes under Section 105(a) of the Bankruptcy Code.

4. Courts may be less likely to authorize retention where special counsel continues to represent adverse party, even in an unrelated matter.

   - In re Am. Energy Trading, Inc., 291 B.R. 154 (Bankr. W.D. Mo. 2003) (denying trustee's application to retain special counsel for prosecution of malpractice action against debtor's former attorney because the trustee's choice continued to represent debtor's second largest creditor in pending appeal of case that gave rise to the malpractice action).

   - In re Premier Farms L.C., 305 B.R. 717 (Bankr. N.D. Iowa 2003) (denying employment application of special counsel in light of counsel's ongoing representation of debtor's only secured creditor).

C. Conflicts Counsel

- Trustee, debtor or committee may seek employment of "conflicts counsel" to handle matters for which general counsel is conflicted. See, e.g., In re Enron Corp., No. 02-Civ-5638, 2003 WL 223455 (S.D.N.Y. Feb. 2, 2003).

- Conflicts counsel **must** be retained under Section 327(a) and not Section 327(e).

IV. Standards Imposed on Debtors' Professionals Under Bankruptcy Code

A. Two-Pronged Standard

1. Adverse Interest

(a) Bankruptcy Code does not define "adverse interest," but cases have held that the key inquiries are whether the professional:

- Has a "meaningful incentive to act contrary to the best interests of the estate and its sundry creditors." In re Martin, 817 F.2d 175, 180 (1st Cir. 1987);

- Possesses or asserts any economic interest that would lessen the value of the bankruptcy estate or would create either an actual or potential dispute with the estate as a rival claimant. In re Roberts, 46 B.R. 815, 827 (Bankr. D. Utah 1985);

- Has a "predisposition or interest under circumstances that render ... a bias" against the estate. In re Roberts, 46 B.R. 815, 827 (Bankr. D. Utah 1985);

- Has "any interest or relationship, however slight, 'that would even faintly color the independence and impartial attitude required by the Code and Bankruptcy Rules.'" In re Granite Partners, L.P., 219 B.R. 22, 33 (Bankr. S.D.N.Y. 1998); or

- If it is "plausible that another interest may cause the professional to act differently than they would without that other interest . . . " In re Worldcom, Inc., 311 B.R. 151, 163 (Bankr. S.D.N.Y. 2004).

(b) Section 327(a) is written in the present tense, thereby focusing on whether the professional currently holds or represents adverse interest. See In re Arochem Corp., 176 F.3d 610 (2d Cir. 1999); In re Huntco Inc., 288 B.R. 229 (Bankr. E.D. Mo. 2002).

(c) Coupled with the disinterested requirement, "this provision 'serves the important policy of ensuring that all professionals appointed pursuant to Section 327(a) tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities.'" Beal Bank v. Waters Edge Ltd. P'ship, 248 B.R. 668, 695 (Bankr. D. Mass. 2000) (citations omitted).

2. Disinterested Person

- Section 101(14) of the Bankruptcy Code defines a "disinterested person" as one who:

  (A) Is not a creditor, an equity security holder, or an insider;

  (B) 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; and

  (C) 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.

B. Debtor Counsel's Fiduciary Duty to Estates

1. Some courts have ruled that counsel to a debtor in possession, like the debtor itself, has a fiduciary duty to the estate, especially where a debtor is insolvent.

- In re JLM, Inc., 210 B.R. 19 (2d Cir. BAP 1997) (authorizing fees to debtor's law firm that had refused controlling shareholder's instructions to move for dismissal of bankruptcy case, on basis that counsel's actions were consistent with fiduciary duties to creditors and estate).

- In re Source Enter., Inc., No. 06-11707, 2008 WL 850229, *14 (Bankr. S.D.N.Y. March 27, 2008) (counsel to D.I.P. breached fiduciary duty to estate by failing to advise D.I.P. and the bankruptcy court that principal's control over reorganization, including filing an unconfirmable plan, was putting the D.I.P. in breach of its fiduciary duties).

- In re Food Management Group, LLC, 380 B.R. 677 (Bankr. S.D.N.Y. 2008) (denying motion to dismiss chapter 11 trustee's complaint against counsel to D.I.P. for breach of fiduciary duties to estate for alleged facilitation of concealment of relationship between principals of D.I.P. and stalking horse bidder).

- In re Count Liberty, LLC, 370 B.R. 259, 280 (Bankr. C.D. Cal. 2007) (counsel to D.I.P. sanctioned for breach of independent fiduciary duty to adequately counsel the D.I.P. of obligation to preserve the proceeds of an asset sale and the consequences of using cash collateral absent permission of the court).

- In re St. Stephen's 350 East 116th St., 313 B.R. 161, 171 (Bankr. S.D.N.Y. 2004) (counsel to D.I.P. breached fiduciary duty to estate by failing to supervise D.I.P.'s professionals and D.I.P. and for failure to comply with Bankruptcy Rules and U.S. Trustee guidelines).

- In re Vebeliunas, 231 B.R. 181, 194 (Bankr. S.D.N.Y. 1999) (stating that a trustee's counsel "has a fiduciary duty on behalf of the trustee, the estate and the debtor to carry out [its tasks] impartially").

- In re Wilde Horse Enterprises, Inc., 136 B.R. 830, 840 (Bankr. C.D. Cal. 1991) ("Because the attorney for the debtor in possession is a fiduciary of the estate and an officer of the Court, the duty to advise the client goes beyond responding to the client's request for advice. It requires an *active* concern for the interests of the estate, and its beneficiaries, the unsecured creditors").

- In re Texasoil Enters., Inc., 296 B.R. 431, 435 (Bankr. N.D. Texas 2003) (although counsel for debtor-in-possession may not owe a fiduciary duty directly to the creditors, it "does have an obligation to ensure the debtor properly maintains the estate").

- In re J&M Dev. of Cass County, Inc., No. 04-41065-JWV, 2004 WL 1146451 at *2 (Bankr. W.D. Mo. May 19, 2004) ("A Chapter 11 debtor in possession acts in a fiduciary capacity to creditors of the estate; thus, a debtor in possession has an obligation not to act in a manner that could damage the estate or hinder a successful reorganization.... [t]hat fiduciary obligation extends to the selection of counsel to represent the debtor in possession").

- But see ICM Notes, Ltd. v. Andrews & Kurth, L.L.P., 278 B.R. 117 (S.D. Tex. 2002) (finding that debtor's counsel has no fiduciary duty to particular creditors); Hansen, Jones & Leta, P.C. v. Segal, 220 B.R. 434 (D. Utah 1998) (finding that debtor's counsel has no fiduciary duty to estate); In re Sidco, Inc., 173 B.R. 194 (E.D. Cal. 1994) (same).

2. Courts and commentators have recognized that imposing a fiduciary duty to the estate upon debtor's counsel creates possible tension with the attorney-client relationship.

- In re Cenargo Int'l, Plc, 294 B.R. 571, 599 (Bankr. S.D.N.Y. 2003) ("Whether counsel to a debtor in possession has a fiduciary duty to the estate and creditors (as opposed to a duty to a client that has a fiduciary duty to the estate and creditors) and the extent of such duty, are developing concepts, in part because the articulation of an overly broad duty might impose an unwarranted strain on the attorney-client relationship and the attorney-client privilege.").

3. If the debtor in possession is violating its fiduciary duties to the estate, debtor's counsel may have an ethical obligation to inform the court or seek to withdraw from the case.

   - "[B]ecause bankruptcy causes fundamental changes in the nature of corporate relationships, obligating the corporation's board of directors to consider the best interests of creditors, and because counsel for the debtor in possession has fiduciary obligations not ordinarily foisted upon the attorney-client relationship, the attorney for the debtor in possession may not simply resign where the client refuses the attorney's advice concerning the client's fiduciary obligations to the estate and its creditors. Counsel must do more, informing the court in some manner of derogation by the debtor in possession." In re JLM, Inc., 210 B.R. 19, 26 (2d Cir. BAP 1997) (quotations and citations omitted); accord In re Source Enter., Inc., No. 06-11707, 2008 WL 850229, *15 (Bankr. S.D.N.Y. March 27, 2008); In re Wilde Horse Enterprises, Inc., 136 B.R. 830 (Bankr. C.D. Cal. 1991).

C. Actual vs. Potential Conflicts

- See generally In re Marvel Entm't Group, Inc., 140 F.3d 463 (3d Cir. 1998).

1. Actual Conflict → *Per se* disqualification under Section 327(a).

   - In re Internet In A Mall, Inc., 216 F.3d 1083 (9th Cir. 2000) (debtor's counsel automatically disqualified because it held adverse interest and court refused suggestion that counsel to creditors' committee could represent the debtor with regard to the adverse interest party, stating "[counsel] does not cite any authority allowing this type of piecemeal representation of the debtor, and we have found none.").

     - In re Elder, 321 B.R. 820 (Bankr. E.D. Va. 2005) ("'[T]he determination as to whether an actual conflict of interest existed … must be guided by federal bankruptcy law and not state law. State law, including rules of professional conduct, while informative, are not determinative").

2. Potential Conflict → Court has discretion to disqualify.

- Potential conflicts can be as harmful and disqualifying as actual conflicts because they create the lingering appearance that independent judgment and impartiality may be compromised. See In re Granite Partners, L.P., 219 B.R. 22 (Bankr. S.D.N.Y. 1998).

- Some courts have determined that a potential conflict is a sufficient basis for disqualification unless "'every competent professional in a particular field is already employed by a creditor or a party-in-interest', or 'if the possibility that the potential conflict will become actual is remote.'" In re Woodworkers Warehouse, Inc., 303 B.R. 740, 742 (Bankr. D. Del. 2004) (citations omitted); see also Beal Bank v. Waters Edge Ltd. P'ship, 248 B.R. 668, 695 (D. Mass. 2000) ("[A]n inquiry does not have to ask 'whether a conflict exists . . . but whether *a potential conflict or the perception of one* renders the lawyer's interest materially adverse to the estate or the creditors.'") (citations omitted).

- Some courts have criticized the distinction between actual and potential conflicts. See, e.g., In re Kendavis Indus. Int'l, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988).

V. Examples of Disinterestedness or Adverse Interests Under Section 327

A. Prior or Current Representation of Creditor

1. Under 327(c) of the Bankruptcy Code, employment or representation of creditor is not *per se* grounds for disqualification, unless:

   (a) Objection by creditor or United States Trustee; and

   (b) Actual conflict exists.

2. Professionals that *currently* represent creditors are less likely to be disinterested than professionals that *previously* represented creditors. See 11 U.S.C. § 327(a) (written in present tense).

- Compare In re Winthrop Hosp., Inc., 146 B.R. 315 (Bankr. D. Mass. 1992) (denying retention of accountants who continued to perform audit services for member of creditors' committee), with In re Muma Servs., Inc., 286 B.R. 583 (Bankr. D. Del. 2002) (permitting counsel to represent creditors' committee after determining counsel's brief past representation of creditor in unrelated bankruptcy case did not cause it to possess an adverse interest or render it not disinterested).

- See also Premier Farms L.C., 305 B.R. 717 (Bankr. N.D. Iowa 2003) (disqualifying counsel for debtor that also represented debtor's only secured creditor, a bank, on unrelated matters because the representation of the bank constituted a potential, if not actual, conflict that rendered counsel not disinterested).

- See also In re Git-N-Go Inc., 321 B.R. 54 (Bankr. N.D. Okla. 2004) (disqualifying counsel for debtor that also represented debtor's holding company and the debtor's single largest unsecured creditor, because possible issues of characterization of debt and equity may have arisen and could have created an atmosphere where continued representation of holding company would "color and influence" the advice rendered to the debtor for the benefit of the estate).

3. The U.S. Trustee is less likely to object to retention where the creditor that the professional currently represents provides less than 1% of the annual revenue of that professional's firm.

   - But see Premier Farms L.C., 305 B.R. 717 (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).

4. Special purpose counsel is disinterested if representation of creditor does not create conflict with respect to the matter for which that professional has been retained.

   (a) Although the language of Section 327(e) refers only to counsel that has represented the debtor (not creditors), courts have applied Section 327(e) by analogy to attorneys who have represented creditors.

      - In re Arochem Corp., 176 F.3d 610 (2d Cir. 1999) (permitting former counsel to creditor of debtor in action against certain banks to represent trustee as special counsel to prosecute separate actions against same banks because creditor's interests in current action were identical to that of the trustee)

      - In re Nat'l Century Fin. Enters., Inc., 298 B.R. 124 (Bankr. S.D. Ohio 2003) (authorizing employment of special counsel, which also represented noteholders that were creditors of the debtor, to pursue avoidance and breach of fiduciary duty actions on which debtors and noteholders shared identity of interest); see also In re Peters Contracting, Inc., 301 B.R. 857 (Bankr. M.D. Tenn. 2003).

      - In re Johnson, 312 B.R. 810 (E.D. Va. 2004) (authorizing law firm to serve as special counsel to Chapter 7 trustee

and simultaneously represent one of debtors' creditors because firm was not operating under an actual conflict of interest).

(b) But see Meespierson Inc. v. Strategic Telecom, Inc., 202 B.R. 845 (D. Del. 1996) (reversing order authorizing employment of counsel for special matter on basis that such counsel had represented a shareholder and creditor and that the less stringent standards of § 327(e) applied only to counsel that had previously represented the debtor).

- But see In re Elder, 321 B.R. 820 (Bankr. E.D. Va. 2005) (denying trustee's application to retroactively employ counsel and creditor's motion for payment of counsel's fees as an administrative expense; § 327(e) forbade such retention/compensation where counsel had simultaneously represented a creditor, which created an actual conflict of interest).

B. Prior Representation of Debtor

1. Section 1107(b) provides that a person is not disqualified solely because of such person's employment by, or representation of, the debtor before the petition date.

   - In re Creative Rest. Mgmt., Inc., 139 B.R. 902 (Bankr. W.D. Mo. 1992) (law firm not disqualified as a result of its prepetition representation of debtors or its receipt of payment for such representation).

2. However, Section 1107(b) is not an exception to the disinterestedness requirement, and the relevant inquiry will turn on whether that person is disinterested or has an interest adverse to the estate.

   - In re Middletown Arms Ltd. Partnership, 934 F.2d 723, 724 (6th Cir. 1991) (explaining that § 1107(b)'s exception to § 327(a) is very narrow and only applies to professionals who are disqualified solely because of their prior employment by the D.I.P.).

   - In re Mercury, 280 B.R. 35 (Bankr. S.D.N.Y. 2002) (denying any compensation to chapter 7 trustee's special counsel that had served as debtors' prepetition attorney in personal injury action and sought bankruptcy court approval of unfavorable settlement that debtors had rejected before the petition date); see also In re LKM Indus., Inc., 252 B.R. 589 (Bankr. D. Mass. 2000) (citing cases).

C. Professional as Creditor of the Debtor

1. As a general rule, a professional that has an outstanding claim against the estate is not disinterested and will be disqualified under Sections 327(a) or 327(e). See 11 U.S.C. § 101(14)(A) (definition of disinterestedness).

   - United States Trustee v. Price Waterhouse, 19 F.3d 138 (3d Cir. 1994) (denying employment of accountants with prepetition claims against debtor).

   - In re CIC Inv. Corp., 175 B.R. 52 (9th Cir. BAP 1994) (disqualifying law firm with secured claim against debtor).

2. Waiver of claim by the professional typically resolves any conflict arising from the prepetition claim.

   - In re Metro. Enviro., Inc., 293 B.R. 871 (Bankr. N.D. Ohio 2003); In re Adam Furniture Indus., Inc., 158 B.R. 291 (Bankr. S.D. Ga. 1993); In re Hub Bus. Forms, Inc., 146 B.R. 315 (Bankr. D. Mass. 1992).

3. Receipt of a retainer is not a proper basis for *per se* disqualification.

   - Although a holder of security retainer is secured creditor, courts have held that receipt of security retainer is insufficient, on its own, to create a disqualifying adverse interest.

   - To minimize risk of disqualification or disgorgement, professionals should disclose any retainers and use them to pay fees only when authorized by the court. See In re Dearborn Constr., Inc., No. 02-00508, 2002 WL 31941458 (Bankr. D. Idaho Dec. 20, 2002).

D. Receipt of Potential Preference or Fraudulent Transfer by Professional

1. Receipt of potential preferential and/or fraudulent transfers creates an actual conflict that elevates the likelihood of disqualification, which may prevent the court from approving retention even if the professional agrees to return the payments/transfers and waive any related claims.

   - In re Fleming Cos., 305 B.R. 389 (Bankr. D. Del. 2004) (denying retention of turnaround advisor and disallowing compensation for services rendered because of a preferential payment received from the debtor which created actual conflict).

   - In re First Sec., Inc., 180 F.3d 504 (3d Cir. 1999) (ruling that transfer to debtor's counsel of restricted stock in another company as payment of prepetition legal fees was a preference and consequently disqualifying counsel).

- In re Pillowtex, 304 F.3d 246 (3d Cir. 2002) (disqualifying law firm that received $1 million payment, some of which related to non-bankruptcy work, during the 90-day preference period because there was a facially plausible claim of a substantial preference, even though law firm agreed to disgorge any fees subsequently found to be preferential and to waive any claim resulting from the disgorgement).

- But see In re Enron Corp., No. 02-Civ-5638, 2003 WL 223455 (S.D.N.Y. Feb. 2, 2003) (holding that law firm representing creditors' committee was disinterested despite receipt of potential preference because law firm waived any rights to challenge examiner's findings of a preference).

2. To minimize preference risks, bankruptcy professionals may seek a retainer from a prospective debtor and draw upon retainer during the prepetition period to pay fees. In addition, all fees should be paid in the ordinary course, under ordinary terms and methods.

3. The issue may be neutralized by an investigation by conflicts counsel and the agreement of the preference recipient to disgorge the amount that conflicts counsel determines to be avoidable.

E. Professional as Equity Interest Holder in the Debtor

- Professionals that own an equity interest in debtors or have a significant relationship to equity interest holders have been disqualified. See 11 U.S.C. § 101(14)(A) (providing that an equity interest holder is not a disinterested person).

- Compare In re Intech Capital Corp., 87 B.R. 232 (Bankr. D. Conn. 1988) (disqualifying law firm because 16 members held 4% of stock in closely held debtor), with In re O'Connor, 52 B.R. 892 (Bankr. W.D. Okla. 1985) (law firm not disqualified even though its members held $500 in shares of debtor).

F. Professional as Officer or Director of Debtor

- Professionals that are officers or directors of debtors have been disqualified. See 11 U.S.C. § 101(14)(B) (definition of insider). There is a split of authority, however, as to whether disinterestedness must be imputed to entire law firm.

- Compare In re Keravision, Inc., 273 B.R. 614 (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), with In re Capitol Metals Co., 228 B.R. 724 (B.A.P. 9th Cir. 1998) (applying former §101(14)(D) to disqualify debtor's law firm because partner had served as chief financial officer during prepetition period).

G. Relationship to Target of Investigation

- Professionals with connections to potential target of investigations concerning breach of fiduciary duty, fraud, avoidance or similar causes of action have been disqualified.

- In re Granite Partners, L.P., 219 B.R. 22 (Bankr. S.D.N.Y. 1998) (denial of fees and expenses charged by counsel retained pursuant to §327(a) for an investigation of claims into matters not properly disclosed, where law firm represented potential target of investigation in other matters).

H. Relationship to Insider of Debtor

1. Professionals that have strong relationships with insiders of debtors may not be disinterested because, among other concerns, insiders are often creditors or targets of investigation by the debtors.

2. Courts have disqualified professionals that have been compensated or guaranteed fees by insiders.

    - In re Metro. Enviro., Inc., 293 B.R. 871 (Bankr. N.D. Ohio 2003) (vacating retention order and disgorging fees received by counsel due to conflict created when insiders guaranteed payment of fees).

    - Bergrin v. Eerie World Entm't LLC, No. 3-Civ-4501, 2003 WL 22861948 (S.D.N.Y. Dec. 2, 2003) (disqualifying law firm that had received substantial payment from an insider and subsequently failed to pursue potential avoidance claims against such insider).

    - But see In re Campbell-Erskine Apothecary, Inc., 302 B.R. 169 (Bankr. W.D. Pa. 2003) (payment of $850 filing fee by debtor's sole shareholder and executive vice president was not sufficient for disqualification); In re Missouri Mining, Inc., 186 B.R. 946 (Bankr. W.D. Mo. 1995) (payment of $15,000 retainer by insider was insufficient to render law firm not disinterested).

3. Prior representation of insider may provide cause for disqualification or denial of compensation.

    - In re Angelika Films 57th, Inc., 227 B.R. 29 (Bankr. S.D.N.Y. 1998) (denying fee application of debtor's counsel whose retention had previously been approved, based upon counsel's filing of a motion seeking to sell a lease at a below-market price to debtor's majority shareholder who had been represented by debtor's counsel).

    - Rome v. Braunstein, 19 F.3d 54 (1st Cir. 1994) (denying fee application of debtor's counsel that represented both sole

shareholder/ president of debtor and family member of shareholder prior to the petition date).

- In re EZ Links Golf, LLC, 317 B.R. 858 (Bank. D. Colo. 2004) (denying retention of debtor's proposed counsel because it had important and consequential relationships with parties that were inseparable with the debtor and, although proposed counsel did not hold an adverse interest, it was therefore not disinterested).

- In re Big Mac Marine, Inc., 326 B.R. 150 (B.A.P. 8th Cir. 2005) (affirming an order of the District Court denying motion to vacate prior order denying Chapter 11 debtor's application to retain attorney because attorney simultaneously represented debtor's principals, its largest creditors, in their individual bankruptcy proceedings, which created a conflict of interest).

- But see In re Water's Edge L.P., 251 B.R. 1 (Bankr. D. Ma. 2000) (law firm not disqualified after it disclosed that it had previously represented insider who funded plan and also currently represented family members of debtor's sole shareholder).

I. Representation of Multiple Related Debtors or Affiliates

- Courts will closely scrutinize the use of the same trustee or its professionals in multiple, related cases where there are interrelated claims.

- In re BH & P, Inc., 949 F.2d 1300 (3d Cir. 1991) (disqualifying trustee and counsel who represented estates in three related chapter 7 cases due to potential inter-debtor claims, although refusing to adopt a *per se* bar to employment of single trustee).

- In re Coal River Res., Inc., 321 B.R. 184 (W.D. Va. 2005) (affirming Bankruptcy Court's disqualification of law firm who represented two of the four debtors in a jointly administered Chapter 11 proceeding due to inter-company indebtedness, which created an actual conflict of interest).

- But see, In re Adelphia Commc'ns. Corp., 342 B.R. 122 (S.D.N.Y. 2006)(presence of intercompany claims between chapter 11 debtors represented by same counsel does not automatically warrant disqualification).

J. Bias Against Debtor

- Evidence of bias against debtor by trustee or trustee's counsel may provide cause for disqualification.

- In re Vebeliunas, 231 B.R. 181, 186 (Bankr. S.D.N.Y. 1999) (disqualifying trustee's law firm on grounds of bias against the debtor,

as evidenced by partner's alleged statement that he did not believe "anything the debtor said in this case").

K. Familial Connections

- Professionals related to creditors or other parties in interest may be subject to disqualification.

- In re Ponce Marine Farm, Inc., 259 B.R. 484 (D. P.R. 2001) (denying fees to law firm that sought court approval of settlement agreement with creditor-company because lead counsel failed to disclose that its father and brother were investors in the creditor-company).

VI. Special Considerations for Professionals Representing Creditors' Committees

A. Section 1103(b) of the Bankruptcy Code permits a creditors' committee to employ attorneys and accountants that do not "represent any other entity having an adverse interest."

1. Representation of one or more of the creditors of the same class as represented by the committee is not *per se* grounds for disqualification. See 11 U.S.C. § 1103(b).

2. Majority rule is that Section 1103(b) prohibits creditors' committee professional from representing parties with adverse interest in the bankruptcy, but does not preclude counsel from representing adverse parties in matters unrelated to the bankruptcy.

   - In re Pittsburgh Corning, 308 B.R. 716 (Bankr. W.D. Pa. 2004) (denying application of law firm to act as special insurance counsel to creditors' committee because firm had previously represented one of the debtor's two shareholders and therefore suffered from an actual conflict of interest); In re Enron Corp., No. 02-Civ-5638, 2003 WL 223455 (S.D.N.Y. Feb. 2, 2003) (denying motion seeking disqualification of committee counsel that had represented, in matters unrelated to the bankruptcy, creditors of the debtors, bidders for the debtors' assets and investment bankers involved in prepetition transactions); In re Walnut Equip. Leasing Co., 213 B.R. 285 (Bankr. E.D. Pa. 1997) (granting employment application to creditors' committee counsel that had represented, in unrelated matters, indenture trustee for debtor's bonds); Daido Steel Co., Ltd. v. Official Comm. of Unsecured Creditors, 178 B.R. 129 (Bankr. N.D. Ohio 1995) (granting employment application of creditors' committee counsel that had represented, in unrelated matters, purchaser of substantially all of debtor's assets).

3. At least one court, however, has ruled that the requirements of Section 327(a) apply to creditors' committee counsel, on the basis that Section 328(c) authorizes a court to deny fees to a professional

employed under Section 1103 if such professional is not disinterested or holds an adverse interest.

- In re Calabrese, 173 B.R. 61 (Bankr. D. Conn. 1994) (applying § 328(c) in denying employment application for creditors' committee counsel).

4. Representation of secured creditors even in unrelated matters may cause court to disqualify counsel from serving as unsecured creditors' committee counsel. See 11 U.S.C. 1103(b) (permitting representation of creditors of the same class as represented by the committee).

    - In re Calabrese, 173 B.R. 61 (Bankr. D. Conn. 1994) (denying employment application for creditors' committee counsel that represented three secured creditors in unrelated matters on the basis of 11 U.S.C. § 1103(b)).

VII. **Attempts to Cure Conflicts Are Not Always Successful**

A. Disclosure does not eliminate risk of disqualification or disgorgement, even when the court approves retention of professional after reviewing disclosure of potential conflict.

- In re Angelika Films 57th, Inc., 227 B.R. 29 (Bankr. S.D.N.Y. 1998) (denying fee application for debtor's counsel whose retention had previously been approved because counsel represented interests of insider rather than the debtor during course of proceeding).

B. Waiver of a professional's prepetition claims may resolve conflict arising from prepetition claim, unless the waiver relates to a preference or fraudulent transfer claim.

- In re Metro. Enviro., Inc., 293 B.R. 871 (Bankr. N.D. Ohio 2003); In re Adam Furniture Indus., Inc., 158 B.R. 291 (Bankr. S.D. Ga. 1993); In re Hub Business Forms, Inc., 146 B.R. 315 (Bankr. D. Mass. 1992).

C. Termination of Relationship Giving Rise to Conflict

- 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 TWI Int'l, Inc. v. Vanguard Oil and Serv. Co., 162 B.R. 672 (S.D.N.Y. 1994) (permitting attorney to withdraw from representation of debtor's insider in breach of contract action); In re Creative Rest. Mgmt., Inc., 139 B.R. 902 (Bankr. W.D. Mo. 1992) (law firm member resigned as assistant secretary of debtor).

D. Ethical Walls

1. Bankruptcy courts frequently impute disqualification of a single attorney in a law firm to the entire law firm.

    - In re Mortgage & Realty Trust, 195 B.R. 740 (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 (B.A.P. 9th Cir. 1998) (applying former §101(14)(D) to disqualify debtor's law firm because partner had served as chief financial officer during prepetition period).

    - But see Vergos v. Timber Creek, Inc., 200 B.R. 624 (W.D. Tenn. 1996) (holding that Section 327 does not mandate the imputation of an individual's disqualification to that person's law firm); In re Keravision, Inc., 273 B.R. 614 (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).

2. Courts (even in non-bankruptcy contexts) are split as to whether and to what extent the erection of an ethical wall prevents the imputation of a conflict to an entire firm.

    - For cases rejecting the use of ethical walls to prevent imputation of a conflict, see In re Essential Therapeutics, Inc., 295 B.R. 203 (Bankr. D. Del. 2003) (rejecting use of ethical wall and stating that without general rule that ethical wall cannot stem the taint of an imputed conflict, the court would have to undertake a "Herculean task" and interrogate each person in the conflicted parties' firm to determine whether taint has spread); Mortgage & Realty Trust, 195 B.R. 740 (Bankr. C.D. Cal. 1996) (rejecting use of ethical wall and imputing conflict of "of counsel" to entire firm); In re Trust Am. Ser. Corp., 175 B.R. 413, 421 (Bankr. M.D. Fla. 1994) ("[t]he 'Chinese wall' is generally not an acceptable means of conflict avoidance where the same professional organization actively represents two adverse interests."); see also Mitchell v. Metro. Life Ins. Co., Inc., No. 01-CIV.-2112-WHP, 2002 WL 441194 at *9 (S.D.N.Y. Mar. 21, 2002) ("[t]he Second Circuit has expressed consistent skepticism about screening as a remedy for conflicts of interests . . . [and c]ourts have only approved screening in the limited circumstances where a conflicted attorney possesses information unlikely to be material to the current action and has no contact with the department conducting the current litigation . . . .") (internal citations omitted).

- For cases supporting the use of ethical walls to prevent imputation of a conflict, see In re Cygnus Oil and Gas Corp., 2007 WL 1580111 (Bankr. S.D. Tex. May 29, 2007) (rejecting per se rule that single member's lack of disinterestedness is imputed to entire firm); In re Enron Corp., No. 02-Civ-5638, 2003 WL 223455 (S.D.N.Y. Feb. 2, 2003) (approving use of ethical wall around lawyers and staff of creditors' committee law firm who had previously represented parties with adverse interests); Vergos v. Timber Creek, Inc., 200 B.R. 624, 630 W.D. Tenn. 1996) (concluding that "screening devises may be employed [by the debtor's law firm] to guard against any infiltration" of the disqualified lawyer's personal interests); In re Chicago South Shore and South Bend R.R., 101 B.R. 10 (Bankr. N.D. Ill. 1989) (holding that debtor's law firm had adequately screened lawyer who had previously represented a major creditor); see also In re Kaiser Group Int'l, Inc., 272 B.R. 846 (Bankr. D. Del. 2002) (holding that creditor had waived right to seek disqualification of debtor's counsel by consenting to representation if counsel erected an ethical wall).

3. When a conflict concerns counsel's prior representation of an adverse interest, courts have applied the "substantially related" test in determining whether counsel could erect an ethical wall to prevent imputation.

    - According to this test, a conclusive, irrebuttable presumption of the existence of shared confidences will exist when a law firm switches sides on a 'substantially related' matter and no measure of screening mechanisms can prevent disqualification. See Desloover v. Daniels, 1999 WL 417322 at *3 (N.D. Ill. 1999) (citing Analytica, Inc. v. NPD Research, Inc., 708 F.2d 1263, 1266 (7th Cir. 1983)("'[S]ubstantially related' ... means: if the lawyer could have obtained confidential information in the first representation that would have been relevant in the second); see also, Battagliola v. Nat'l Life Ins. Co., (S.D.N.Y. 2005) (applying the "substantially related" test in disqualifying attorney).

E. Conflict Waivers

1. Although a client cannot waive *actual* conflicts of interest in the bankruptcy context through informed consent, courts are divided as to whether such consent/waivers will cure *potential* conflicts of interest.

2. For cases refusing to enforce waivers of actual or potential conflicts in light of Section 327, see In re Congoleum Corp., 426 F.3d 675, 692 (3d Cir. 2005); In re Git-N-Go, Inc., 321 B.R. 54 (Bankr. N.D. Okla. 2004); In re Premier Farms L.C., No. 03-04632F, 2003 WL

23272441 (Bankr. N.D. Iowa Dec. 16, 2003); In re Perry, 194 B.R. 875 (E.D. Cal. 1996); In re Diamond Mortg. Corp. of Illinois, 135 B.R. 78 (Bankr. N.D. Ill. 1990).

3. For cases recognizing effect of waivers with respect to potential conflicts, see In re Head, 110 B.R. 621 (Bankr. M.D. Ga. 1990); In re Direct Satellite Communications, Inc., 96 B.R. 507 (Bankr. E.D. Pa. 1989); see also In re Muma Servs., Inc., 286 B.R. 583 (Bankr. D. Del. 2003) (determining that creditor had at least impliedly waived a potential conflict by not objecting to special counsel's retention for purposes of pursuing avoidance action against former client).

VIII. Conflicts Counsel as the "Fix"

1. Because of the inherent short-comings in the disclosure, waiver and "firewall" methods of curing conflicts, numerous courts have accepted the effectiveness of the retention of conflicts counsel to address any matters where debtor's general counsel cannot represent the debtor either because of a conflict or the appearance of impropriety. See, e.g., In re Enron Corp., 2002 WL 32034346 (Bankr. S.D.N.Y. 2002) (listing conflicts counsel as a "procedure to address conflict of interest issues"), aff'd In re Enron Corp., 2003 WL 223455 (S.D.N.Y. 2003); see, also, In re Cook, 223 B.R. 782, 791 (10th Cir. B.A.P. 1998) (hiring conflicts counsel would have been effective curative measure had it been done at the beginning of the case); In the Matter of G.E.C. Secs., Inc., 331 F.2d 655, 656 (2d Cir. 1964) (suggesting that special counsel should be retained in the event a disabling conflict may arise); see also, Katz v. Kilshemer, 327 F.2d 633, 636 (2d. Cir. 1964) (same); cf. In re Internet In A Mall, Inc., 246 F.2d 1083 (9th Cir. 2000) (not allowing "piecemeal representation" of the debtor in a situation where debtor's counsel did not disclose conflict and only after disqualification was sought suggested that the creditors' committee counsel should assume the representation).

2. More than one court has held that when counsel has a potential conflict, disqualifying them at an early stage in the case will avoid problems and necessary delays and expense further down the road. "These problems can be avoided if a professional without any potential conflict of interest is employed by the debtor from the outset." See, In re J&M Dev. Of Cass County, 2004 WL 1146451 (Bankr. W.D. Mo. 2004) (citing In re BH&P, Inc., 103 B.R. 556 (Bankr. N.J. 1989).

IX. Consequences of Existence of Conflict

A. Disqualification (which may be accomplished by vacating order that approved retention)

- Completion of duties (or emergence from bankruptcy) does not necessarily moot a motion for disqualification or appeal of a retention

order. See In re Federated Dep't Stores, Inc., 44 F.3d 1310 (6th Cir. 1995) (denying motion to dismiss on ground that the validity of the retention order had collateral consequences as to compensation, regardless of whether work was completed or debtor had emerged from bankruptcy).

B. Denial of Compensation

1. Under Section 328(c) of the Bankruptcy Code, the court "may" deny compensation and reimbursement of expenses, if, at any time during the bankruptcy, the professional is not disinterested or represents an interest adverse to the estate.

2. There is a split of authority concerning whether the court has discretion to compensate any professional that was actually yet improperly retained.

   - For cases holding that the court has discretion, but is not required, to deny compensation to professionals that were actually but improperly retained, see In re Crivello, 134 F.3d 831 (7th Cir. 1998) (citing cases); cf. In re Milwaukee Engraving Co., 219 F.3d 635 (7th Cir. 2000) (deciding that disinterested professional that was not retained by order of the court was not entitled to any compensation under § 503(b)(1)(A)).

   - For cases holding that courts have no discretion to compensate professionals that were improperly retained, see In re Federated Dep't Stores, Inc., 44 F.3d 1310 (6th Cir. 1995) (deciding that disgorgement of fees paid to investment banker that was not disinterested, even though bankruptcy court had previously approved retention and work was completed).

3. Range of Fee Sanctions

   (a) Total Disgorgement or Denial of Fees – Court may deny all fees, even where some/all services performed benefited the estate.

      - In re Congoleum Corp., Case No. 03-51524, March 27, 2006 (Dkt. # 3800) (ordering disgorgement of 100% of fees of D.I.P.'s special insurance counsel earned over two year representation of D.I.P. after Third Court vacated Bankruptcy Court and District Court's orders authorizing retention).

      - In re Angelika Films 57th, Inc., 227 B.R. 29 (Bankr. S.D.N.Y. 1998).

      - In re Bruno, 327 B.R. 104 (Bankr. E.D.N.Y. 2005).

(b) Partial Disgorgement or Denial of Fees – Even if the court determines that a professional is not disinterested or has adverse interests, the court might allow a portion of fees and expenses or grant the professional an administrative claim.

- In re Authorized Factory Serv., Inc., 283 B.R. 684 (Bankr. W.D. Pa. 2002) (permitting payment of $4,500 out of $28,000 in fees on basis that disinterested accountant had conferred some benefit to estate).
- In re Greystone Holdings, L.L.C., No. 02-64605, 2003 WL 23281532 (Bankr. N.D. Ohio Aug. 21, 2003) (denying application for employment under § 327(a) yet allowing compensation of all fees and expenses in light of special circumstances and benefit conferred on the estate).
- In re Metro. Enviro., Inc., 293 B.R. 871 (Bankr. N.D. Ohio 2003) (allowing disinterested professional to retain some fees yet disgorging those fees received after conflict arose).
- But see In re Milwaukee Engraving Co., 219 F.3d 635 (7th Cir. 2000) (reversing decision of bankruptcy court to grant a portion of the fees under § 503(b) to law firm whose application for employment was denied).

(c) Denial of Unpaid Compensation.

- In re CF Holding Corp., 164 B.R. 799 (Bankr. D. Conn. 1994) (denying financial advisor $800,000 in unpaid fees yet permitting advisor to keep $1.4 million in previously paid fees because advisor voluntarily disclosed conflict).

(d) Denial of Fees in Amount Equal to Fees Paid to Investigate Disinterestedness.

- See, e.g., In re Granite Partners, L.P., 219 B.R. 22 (Bankr. S.D.N.Y. 1998).

C. Malpractice Claim by Debtors

1. See, e.g., In re SonicBlue Inc., et al., 03-51775 (Bankr. N.D. Cal. April 24, 2009) (approving $10 million settlement of malpractice action against debtors' general bankruptcy counsel for breach of fiduciary duty based on failure to disclose disqualifying conflict of interest).

X. Professionals Must Disclose All Connections

A. Duty of Disclosure – Full disclosure is necessary for the court to determine whether a professional to be employed by the estate is disinterested or has an adverse interest, and thus whether retention should be allowed.

1. 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 top 20 or 30 unsecured creditors, plus all secured creditors);

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

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

2. The parties in interest that should be identified pursuant to Bankruptcy Rule 2014 will vary based upon the facts of a particular case, but 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.

3. Other matters/information that professionals must disclose:

   (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).

      - See 11 U.S.C. § 329(a); see also In re Kendavis Indus. Int'l, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988) (disgorging undisclosed retainer); In re Metro. Enviro., Inc., 293 B.R. 871 (Bankr. N.D. Ohio 2003) (disgorging fees in light of undisclosed guaranty of fees by insider).

(c) Amounts received during the preference period.

- In re James River Coal Co., 2008 WL 764215, (M.D. Tenn. March 21, 2008) (affirming bankruptcy court's dismissal of avoidance action to recover pre-petition payments to debtor's investment banker based on *res judicata* effect of disclosure of the transfers in professionals' retention and fee applications); In re PHP Healthcare Corp., No. 98-2608JKF, 2002 WL 923932 (Bankr. D. Del. May 7, 2002) (permitting avoidance action to proceed to trial and rejecting accounting firm's argument that court orders approving its retention and final fee application were res judicata as to potential preference received by firm, due to failure of firm to disclose potential preferential payment); In re BCP Mgmt., Inc., 320 B.R. 265 (Bankr. D. Del. 2005) (same).

(d) Amounts held by professional in trust or as custodian.

- In re Sabre Int'l, Inc., 289 B.R. 420 (Bankr. N.D. Ohio 2003) (denying fees because accounting firm's original affidavit did not disclose that it was holding $46,000 in trust on account of prepetition services).

(e) Joint defense agreements executed by professionals and parties that are adverse to estate.

- In re Molten Metal Tech., Inc., 289 B.R. 505 (Bankr. D. Mass. 2003) (denying final fee application and disgorging interim fees paid to special counsel for failing to disclose that it was a party to a joint defense agreement restricting its ability to disclose information concerning insiders that possessed adverse interests to the estate).

(f) Information concerning conflict waivers by major creditors.

- In re Jore Corp., 298 B.R. 703 (Bankr. D. Mont. 2003) (vacating retention order, disqualifying counsel and disgorging substantially all fees because counsel failed to disclose "no litigation" exception in conflict waiver by debtor's post-petition lenders).

4. All connections must be disclosed, regardless of relevance. Coy or incomplete disclosures that leave the court to ferret out relevant information are insufficient.

- In re Hot Tin Roof, Inc., 205 B.R. 1000, 1003 (1st Cir. BAP 1997) (stating that attorney "cannot pick and choose which connections are relevant or trivial").

- In re Leslie Fay Cos., Inc., 175 B.R. 525, 536 (Bankr. S.D.N.Y. 1994) (stating that professional seeking retention cannot make unilateral determination "regarding relevance of a connection").

- In re Bruno, 327 B.R. 104 (Bankr. E.D.N.Y. 2005) (stating that the duty of disclosure is of such importance, that the failure of an attorney to disclose all relevant connections is "an independent basis for the disallowance of fees").

5. Disclosure should be made in affidavit accompanying retention application. Court should not have to examine debtor's statement of financial affairs or other bankruptcy pleadings in order to determine whether conflicts exist.

6. The inadvertent or negligent failure to disclose does not excuse violations of Rule 2014(a).

   - In re BH & P, Inc., 949 F.2d 1300, 1318 (3d Cir. 1991) (stating that "'[n]egligence does not excuse the failure to disclose a possible conflict of interests'") (citations omitted).

7. Professionals have a continuing duty to update or supplement disclosure if potential conflicts arise.

   - Boilerplate provisions in an affidavit stating that the professional may represent unspecified creditors or parties in interest in unrelated future transactions is insufficient disclosure of future connections or potential conflicts.

   - In re Granite Partners, 219 B.R. 22 (Bankr. S.D.N.Y. 1998) (reducing fees and expenses of trustee's law firm that violated Rule 2014(a) when it did not supplement its original disclosure after its representation of adverse client grew from 5 to 400 cases during the bankruptcy proceedings).

XI. Consequences of Failure to Disclose

A. Professionals that fail to disclose potential conflicts in a spontaneous, timely and complete manner "proceed at their own risk" and may suffer disqualification and disgorgement of all fees.

- Rome v. Braunstein, 19 F.3d 54 (1st Cir. 1994) (affirming bankruptcy court's order that denied fee application of debtor's counsel due to disqualifying conflicts).

- In re R & R Assocs. of Hampton, No. 91-10983-MWW, 2003 WL 1233047 (Bankr. D.N.H. 2003) (disgorging all fees paid to law firm after court had already entered final order approving payment of fees because firm failed to disclose prior representation of general partners/insiders of debtor).

B. Potential Consequences

1. Disqualification - Failure to fully disclose all connections under Rule 2014(a) is an independent ground for disqualification.

   - In re Filene's Basement, 239 B.R. 845 (Bankr. D. Mass. 1999) (granting motion for reconsideration and holding that failure to fully disclose potential conflicts was independent grounds for disqualification, without reaching issue of whether attorney is disinterested under § 327); In re Larson, 2004 WL 307182, at *6 (Bankr. D. Idaho 2004) (same).

2. Fee Sanctions

   (a) Disgorgement of All Fees Paid – Decision to disgorge all fees usually turns on whether failure to disclose was willful and knowing.

   (b) Partial Disgorgement

   - Partial disgorgement may occur even where law firm represented debtor in exemplary fashion and caused no actual injury. See In re Leslie Fay Cos. Inc., 175 B.R. 525 (Bankr. S.D.N.Y. 1994) (law firm failed to disclose prior representation of major creditor and connections to potential targets of fraud investigation).

   - Court may disgorge amounts attributable to investigation and prosecution of allegations of disinterestedness or failure to disclose. See In re Leslie Fay Cos., Inc., 175 B.R. 525 (Bankr. S.D.N.Y. 1994).

   - Court may fashion such relief as it finds equitable under circumstances. In re Imperial Corp. of Am., 181 B.R. 501 (Bankr. S.D. Cal. 1995) (disgorging fees to extent law firm performed general counsel services beyond special counsel services for which it was retained and requiring law firm to bear all costs of litigating the disgorgement motion); In re Ponce Marine Farm, Inc., 259 B.R. 484, 491(D. P.R. 2001) (denying compensation after the date that law firm's duty to disclose "'arose unequivocally'"); In re Old Summit Mfg., LLC, 2004 WL 3311426, at *6 (Bankr. M.D. Pa. 2004) (sanctioning law firm that was not disinterested by compelling it to disgorge 50% of postpetition fees received by firm);

   - Law firm that was a creditor of the debtor on the petition date based on prepetition services was not disinterested and compensation for those services were denied. In re Lackawanna Medical Group, P.C., 2004 WL 3311425, at * 7 (Bankr. M.D. Pa. 2004).

(c) Denial of Unpaid Fees

3. Appointment of New Counsel for New Matters

- In re Leslie Fay Cos., Inc., 175 B.R. 525 (Bankr. S.D.N.Y. 1994) (permitting law firm to represent debtor in general reorganization matters, but not with respect to claims reconciliation and avoidance actions).

4. Malpractice Claim by Debtors

5. Criminal Penalties

- 18 U.S.C. § 152 (imposing fines and imprisonment for not more than 5 years for persons who knowingly and fraudulently make a false oath, declaration, verification or statement under penalty of perjury in or in relation to any bankruptcy case).

C. Even if disqualified, a professional may seek fees and expenses as administrative claim pursuant to Section 503 of Bankruptcy Code.

- In re Filene's Basement, 239 B.R. 845, 850 (Bankr. D. Mass. 1999) (permitting law firm, which had been disqualified for failure to disclose, to file application for "reimbursement of actual and necessary expenses").