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CONFLICTS OF INTEREST AND OTHER ETHICAL ISSUES FACING BANKRUPTCY LAWYERS: IS DISINTERESTEDNESS NECESSARY TO PRESERVE THE INTEGRITY OF THE BANKRUPTCY SYSTEM?

Arthur J. Gonzalez*

I. INTRODUCTION**

As the title of today's presentation indicates, the focus of my remarks will be on the ethical issues that face bankruptcy lawyers. I thought it would be helpful to approach these issues by analyzing the ethical considerations that would face an attorney regarding a non-bankruptcy retention under a particular set of facts, and then add to those facts that the client files bankruptcy and seeks to retain the same attorney. For purposes of this discussion, I will assume that the attorney is competent to represent a client in bankruptcy and therefore will not address the ethical requirements regarding competency. However, this is not intended to leave anyone with the impression that the competency issue is any less of an ethical consideration in bankruptcy than in any other area of the law. Following the discussion of the non-bankruptcy retention and the bankruptcy retention, I will then present my own view of what changes in the retention area of bankruptcy practice, if any, should be considered.

* Arthur J. Gonzalez is a United States Bankruptcy Judge for the Southern District of New York. This is the text of the speech, which was modified slightly during oral presentation, Judge Gonzalez gave at the Benjamin Weintraub Distinguished Professorship Lecture. This text has been supplemented by citations and footnotes. Judge Gonzalez would like to recognize the contribution of Heike Vogel, a third year law student at Brooklyn Law School, in providing research and initial drafting assistance.

** I would like to express my gratitude to the Hofstra University School of Law, especially Professor Alan N. Resnick, for inviting me to present the Benjamin Weintraub Distinguished Professorship Lecture. It is a great honor to have been selected to present this lecture at a program named for Benjamin Weintraub. I never had the good fortune to have met Benjamin Weintraub but he is someone whose legacy touches all those who are involved in the field of bankruptcy law.
II. FACTS

Assume that Blue Company, a small manufacturing business, asked its attorney from a small law firm to resolve a dispute with Green Bank. Green Bank has been lending Blue Company operating capital for a number of years and allegedly has a security interest in all of Blue Company’s receivables and inventory. The principal and majority shareholder of the company has personally guaranteed the loan. Finally, the attorney believes that the company is solvent.

As to the attorney’s relationship with Blue Company, it owes her $5,000 for prior work performed on other matters and the bill is a few months overdue. In addition, the attorney formed the corporation a number of years ago and as partial payment received a one percent interest in the company. She has acted as the corporate secretary for a number of years with no compensation. The attorney also represents Green Bank on an ongoing basis in real estate matters, however, she has no intention of trying to represent Green Bank with respect to any of its loans to Blue Company.

To recap, the relationships presented by this fact pattern are:
1) the attorney is a creditor of Blue Company;
2) she is a stockholder of Blue Company;
3) she is a corporate officer of Blue Company;
4) if she accepts this matter, she would be representing Blue Company against another one of her clients, Green Bank;
5) the principal of Blue Company has given Green Bank a personal guarantee; and
6) Blue Company is solvent at the time of its bankruptcy filing.

A. Non-Bankruptcy Conflicts of Interest Analysis

Although a majority of states have adopted the more recently developed Model Rules of Professional Conduct ("Model Rules"), New York State uses the Model Code of Professional Responsibility ("Code") when determining the proper standard of attorney conduct. Since many amendments to the New York Code draw upon the Model

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Rules, pertinent provisions specifically addressing conflicts of interest situations under both statutes will be examined in this Section.  

For purposes of the present discussion, the relevant sections of the New York Code are Disciplinary Rules 5-101(A), entitled “Refusing Employment When the Interest of the Lawyer May Impair Independent Professional Judgment;” 3 DR 5-105, entitled “Refusing to Accept or Continue Employment if the Interests of Another Client May Impair the Independent Professional Judgment of the Lawyer;” 4 DR 5-109, concerning conflicts between the organization as client and the organization’s constituents; 5 and DR 9-101, concerning avoidance of the appearance of impropriety. 6 These disciplinary rules of the New York Code are almost identical to the provisions set forth in the Model Rules, which regulate concurrent conflicts of interest. 7

One concludes from the disciplinary rules that a client is entitled to “undivided loyalty.” In our adversary system, each side has the right to have its position represented to the fullest extent whether in court, negotiating a contract, or any other facet of the law that the attorney’s retention includes. 8 The role then of the advocate must be played out with

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4. Id. app. DR 5-105.
5. See id. app. DR 5-109.
7. See Model Rules of Professional Conduct Rule 1.7; Rule 1.11(a)-(c); Rule 1.12(a); Rule 1.13(a), (d) (1999). The New York Code disciplinary rules relating to conflicts of interest and their Model Rules counterparts are as follows: DR 5-101(A) corresponds to Model Rule 1.7(b); DR 5-105 corresponds to Model Rule 1.7(a), (b); DR 5-109 corresponds to Model Rule 1.13(d); DR 9-101(A) corresponds to Model Rule 1.12(a); and DR 9-101(B) corresponds to Model Rule 1.11(a)-(c).
8. See Monroe H. Freedman, Professionalism in the American Adversary System, 41 Emory L.J. 467, 469 (1992). In his article, Professor Freedman states:

It is within this constitutionalized adversary system, in which individual rights are central, that American lawyers carry out their traditional and essential role. The right to counsel has thus been called “the most pervasive” of rights, because it affects the ability of individuals in society to avail themselves of all other rights.

This is equally true, moreover, in non-litigation settings. Any lawyer who counsels a client, negotiates on a client’s behalf, or drafts a legal document for a client must do so with an actual or potential adversary in mind. When a contract is negotiated, there is a party on the other side. A contract, a will, or a form submitted to a government agency may well be read at some later date with an adversary’s eye, and could become the subject of challenge and litigation. The advice given to a client and acted upon today may strengthen or weaken the client’s position in negotiations or litigation next year. In short, all lawyers, and not just the advocate in the courtroom, necessarily function in the adversary system.

Id. (footnote omitted).
only one goal—to present, within the parameters of the law and ethical considerations, the interests of the client. If an attorney’s loyalties are divided the adversary system has been compromised and confidence in the fairness of such system is diminished. However, it appears that, pursuant to the disciplinary rules, when the “undivided loyalty” issue arises, it can be resolved through disclosure and consent.

B. Analysis of Ethical Considerations in Non-Bankruptcy

The attorney’s relationship to the client as a creditor, stockholder, and corporate officer is addressed in DR 5-101(A), which provides: “Except with the consent of the client after full disclosure, a lawyer shall not accept employment if the exercise of [the lawyer’s] professional judgment on behalf of the client will be or reasonably may be affected by [the lawyer’s] own financial, business, property, or personal interests.” Thus, it appears that after full disclosure and consent of the client, the attorney can continue to represent the client.

As to the personal guaranty, that consideration is covered by DR 5-109(A), which requires the attorney to explain the relationship and the fact that the attorney’s obligations are to the corporate client and not to

9. See MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 5-1 (1980). EC 5-1 provides: The professional judgment of a lawyer should be exercised, within the bounds of the law, solely for the benefit of [the] client and free of compromising influences and loyalties. Neither [the lawyer’s] personal interests, the interests of other clients, nor the desires of third persons should be permitted to dilute [the lawyer’s] loyalty to [the] client.

Id.

10. See Gerald K. Smith, Conflicts of Interest in Workouts and Bankruptcy Reorganization Cases, 48 S.C.L. REV. 793, 810-11 (1997). In his article, Smith states: Conflict rules are essential for a variety of reasons, including the assurance of adequate representation, preservation of confidences and maintaining the integrity of our adversary system. Conflict rules also preserve the intangible bond between client and lawyer. Call it loyalty, call it what you will, we perhaps sense it better than we define it. Our reaction to specific situations is the true litmus test. Perhaps it is our sense of injustice that is involved.

Id. (footnotes omitted).


12. Id. app. DR 5-101(A).

13. See id. In addition to DR 5-101(A), DR 5-105(C) provides: In the situations covered by DR 5-105(A) and (B), a lawyer may represent multiple clients if it is obvious that the lawyer can adequately represent the interest[s] of each and if each consents to the representation after full disclosure of the possible effect of such representation on the exercise of the lawyer’s independent professional judgment on behalf of each.

Id. app. DR 5-105(C).
the individual interests of the client’s principals.\textsuperscript{14} However, from a practical consideration, it could be very difficult for the client’s principal to understand or accept this relationship, especially in a closely held corporation. Regarding Green Bank also being the attorney’s client, a conflict of interest exists that must be addressed before she can accept the engagement.\textsuperscript{15}

Assume that the attorney discloses all of these issues to her client who is not troubled by them. Moreover, the attorney informs the bank of the issue and awaits its response. When the bank responds, it does not have an objection to the attorney representing the company against the bank, and therefore it executes a waiver form.\textsuperscript{16} With respect to all the disciplinary rules mentioned and applied to a non-bankruptcy proceeding, the key is full disclosure and the consent from all parties involved.

\textbf{C. What has Happened by the Above?}

Returning to our fact pattern, Blue Company has been advised of the connections the attorney has—the disclosure requirement. The attorney has also advised Green Bank of any possible conflict. The attorney received consent from both clients. With the disclosure and consent requirements satisfied, the issue is now resolved from a conflicts of interests standpoint. It seems that the attorney has complied with her ethical obligations and all is well. However: Does not the conflict between the interests of each of her clients still exist? Is it still not possible that her loyalty to the company in this action may be compromised or at least appear that it may be compromised?

What has happened by receiving the consent of both, the bank as well as the company, is that their rights with respect to the conflict have been waived and each has accepted that the attorney will act with undivided loyalty to Blue Company. The system has afforded each client the opportunity to exercise its rights.

\textsuperscript{14} See id. app. DR 5-109(A). DR 5-109(A) provides:

When a lawyer employed or retained by an organization is dealing with the organization’s directors, officers, employees, members, shareholders or other constituents, and it appears that the organization’s interests may differ from those of the constituents with whom the lawyer is dealing, the lawyer shall explain that the lawyer is the lawyer for the organization and not for any of the constituents.

\textit{Id.}

\textsuperscript{15} See id. app. DR 5-101(A).

\textsuperscript{16} See id. app. DR 5-105(C). It is important to note that an attorney has to consider all of the aforementioned as to each attorney in her law firm. See \textit{id.} app. DR 5-105(D).
What about the issue of an appearance of impropriety? Should the company not be required to find an attorney that has no relationship with the bank so that the system would not only be fair, but also appear fair?

In spite of the above, it seems that the ethical considerations have been satisfied and the system is protected because each client has been made aware of the connections and has freely chosen to consent to the attorney’s representation of Blue Company. As far as the appearance to the outside, there are only two parties involved, Blue Company and Green Bank; each party has had the opportunity to exercise its rights, and they have chosen to waive them.

If the company were to file bankruptcy and seek to retain the same attorney, is there any difference in the analysis? Should there be any difference?

III. BANKRUPTCY

Bankruptcy is a body of law that, among other things, enables people and companies to be relieved of obligations to pay debts, in part or in full.\textsuperscript{17} Also, it may provide for the continued existence of an entity even though it has not fully complied with its economic obligations.\textsuperscript{18} From a creditor’s vantage point, bankruptcy provides an orderly system to divide a limited fund in an equitable manner.\textsuperscript{19} Whether the debtor is liquidating or reorganizing, the debtor must proceed in a manner which considers the interests of the “estate” that are created at the filing and any class of creditors or equity security holders.\textsuperscript{20}

Both the New York State ethical requirements (or the applicable ethical requirements in the state in which the court is sitting) and \textsection{}327 of the Bankruptcy Code apply in each bankruptcy case.\textsuperscript{21} It seems that

\begin{itemize}
  \item \textsuperscript{17} See, e.g., \textit{In re Jonson}, 17 B.R. 78, 79 (Bankr. S.D. Ind. 1981) ("[T]he purpose of a Chapter 13 plan is to enable a debtor to pay either in full or in part, 'debts which have become too burdensome to meet without the help of the bankruptcy laws.'" (quoting \textit{In re Yee}, 7 B.R. 747, 758 (Bankr. E.D.N.Y. 1980))).
  \item \textsuperscript{18} See \textit{In re Russell}, 60 B.R. 42, 44 (Bankr. W.D. Ark. 1985).
  \item \textsuperscript{19} See Hollytex Carpet Mills, Inc. v. Oklahoma Employment Sec. Comm’n (\textit{In re Hollytex Carpet Mills}, Inc.), 73 F.3d 1516, app. at 1524 (10th Cir. 1996).
  \item \textsuperscript{20} See \textit{In re Fremont Battery Co.}, 73 B.R. 277, 278-79 (Bankr. N.D. Ohio 1987).
  \item \textsuperscript{21} See, e.g., \textit{In re Allboro Waterproofing Corp.}, 224 B.R. 286, 291 n.3 (Bankr. E.D.N.Y. 1998).
\end{itemize}
when you examine the concerns of the New York Code and § 327 of the Bankruptcy Code, the ethical issues are the same. However, bankruptcy differs in that the ethical issues must be viewed in a much broader context; the attorney must consider the interests of the estate as well as each class of creditors and equity holders. Further, in bankruptcy the issue of waiver and consent is far more difficult to address and, in fact, may not even apply in certain circumstances.

Section 327 of the Bankruptcy Code controls the retention of professionals in a bankruptcy case, and refers to the retention of professionals by a trustee. However, § 1107(a) provides that a debtor-in-

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Id. (citation omitted); see In re Caldor, Inc., 193 B.R. 165, 178 (Bankr. S.D.N.Y 1996) (looking to the Code of Professional Responsibility to analyze a conflict of interest under the Bankruptcy Code); In re City Mattress, Inc., 163 B.R. 687, 687-88 (Bankr. W.D.N.Y. 1994) (applying 11 U.S.C. § 327 (1994) to a conflict of interest dispute involving a retainer arrangement including a mortgage on property that the debtor-in-possession used, but did not own).

22. In the interest of time limitations and due to the complexity of the issues surrounding insolvent corporations outside of bankruptcy, this presentation did not address the issue of the ethical obligations counsel to a corporation must consider when representing an insolvent corporation outside of bankruptcy. For example, the fiduciary duty of directors of a corporation extends to creditors once a corporation is insolvent outside of bankruptcy. See In re Kingston Square Assoc., 214 B.R. 713, 720, 735 (Bankr. S.D.N.Y. 1997). A complete analysis of all ethical issues facing bankruptcy lawyers should include a comparison of a lawyer’s ethical obligations concerning an insolvent entity prior to and after filing bankruptcy.

23. See Smith, supra note 10, at 824 n.120 (noting the precarious situation that arises for a bankruptcy attorney because the attorney must represent the interests of the estate, each class of creditors, and the equity holders).

24. See In re Sauer, 191 B.R. 402, 408 (Bankr. D. Neb. 1995); In re B.E.S. Concrete Prods., Inc., 93 B.R. 228, 235 (Bankr. E.D. Cal. 1988) (“[W]aiver is more difficult to obtain in a chapter 11 case because the debtor in possession stands in a fiduciary capacity that constrains its ability to make such a waiver.”).


26. See id. Section 327 states:

(a) Except as otherwise provided in this section, the trustee, with the court’s approval, may employ one or more attorneys, accountants, appraisers, auctioneers, 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 trustee in carrying out the trustee’s duties under this title.

(b) If the trustee is authorized to operate the business of the debtor under section 721, 1202, or 1108 of this title, and if the debtor has regularly employed attorneys, accountants, or other professional persons on salary, the trustee may retain or replace such professional persons if necessary in the operation of such business.

(c) In a case under chapter 7, 12, or 11 of this title, a person is not disqualified for employment under this section solely because of such person’s employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.

(d) The court may authorize the trustee to act as attorney or accountant for the estate if such authorization is in the best interest of the estate.

(e) The trustee, with the court’s approval, may employ, for a specified special purpose,
possession shall have the rights and duties of a trustee.\textsuperscript{27} Therefore, the debtor, as debtor-in-possession, may retain professionals and that retention must comply with § 327. Under § 327(a), "the trustee . . . may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons . . . ."\textsuperscript{28} Although the Code "does not define 'adverse interest' in any of its provisions,"\textsuperscript{29} it provides an extensive definition of "disinterested person" in § 101(14).\textsuperscript{30} Subsections (A) through (D) of § 101(14) list specific types of relationships that prevent professionals from being disinterested and thus disqualify the professional for employment under § 327(a).\textsuperscript{31} "[S]ubsection (E), which is a 'catchall' provision,"\textsuperscript{32} generally disqualifies anyone with "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

\textsuperscript{27} See id. § 1107(a). Section 1107(a) provides:
Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in sections 1106(a)(2), (3), and (4) of this title, of a trustee serving in a case under this chapter.

\textsuperscript{28} Id.

\textsuperscript{29} Id. § 327(a).

\textsuperscript{30} R. Craig Smith, Note, Conflicts of Interest Under the Bankruptcy Code: A Proposal to Increase Public Confidence in the Bankruptcy System, 8 GEO. J. LEGAL ETHICS 1045, 1050 (1995).


indirect relationship to, connection with, or interest in, the debtor or an investment banker... or for any other reason.33

The dual requirements of being disinterested and of not holding or representing an interest adverse to the estate appears to be a unique feature of bankruptcy proceedings which has divided experts in the field.34 Opponents of the employment standards have suggested that the per se disqualification provisions of the disinterestedness standard for professionals employed by the debtor-in-possession should be abandoned and that the Code should define adverse interest similarly to the definition of conflict of interest contained in the Restatement (Third) of the Law Governing Lawyers.35 On the other hand, supporters of the strict anti-conflict rule in bankruptcy cases argue that the unique nature of the bankruptcy process requires an additional standard which ensures that the interests of all parties involved are protected.36 Moreover, proponents reason that given the complex relationships that exist only in bankruptcy proceedings, it is necessary to avoid any appearance of impropriety in order to preserve public confidence in the bankruptcy system.37

Bankruptcy courts are also divided as to the proper application of the employment standards. Some courts strictly follow the per se dis-

35. See Smith, supra note 10, at 898-99. The Restatement Third provides that: "A conflict of interest is involved if there is a substantial risk that the lawyer's representation of the client would be materially and adversely affected by the lawyer's own interests or by the lawyer's duties to another current client, a former client, or a third person." RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 201 (Proposed Final Draft No. 1, 1996).
36. See Warner, supra note 52, at 429.
37. See id. at 429-30.
qualification requirement, and others have adopted a more flexible interpretation of the disinterestedness standard. Before I continue with the discussion of § 327, I would like to briefly discuss Bankruptcy Rule 2014, the disclosure rule without which the purpose of § 327 would be undermined.

A. Disclosure Requirement in Bankruptcy Proceedings

Rule 2014 of the Federal Rules of Bankruptcy Procedure mandates disclosure of actual and potential conflicts of interest. In In re Granite

38. See Childress v. Middleton Arms, L.P. (In re Middleton Arms, Ltd. Partnership), 934 F.2d 723, 725 (6th Cir. 1991) ("[A] court cannot approve the employment of a person who is not disinterested, even if the person does not have an adverse interest."); Pierce v. Aetna Life Ins. Co. (In re Pierce), 809 F.2d 1356, 1362-63 (8th Cir. 1987) (affirming bankruptcy court’s finding that attorney who is a pre-petition creditor is not “disinterested”); Merrimac Assocs. v. Daig Corp. (In re Daig Corp.), 799 F.2d 1251, 1253 (8th Cir. 1986) (holding a management consulting firm that received a stock purchase warrant from the debtor to not be “disinterested”); In re Siliconix, Inc., 135 B.R. 378, 380 (N.D. Cal. 1991) ("[W]e rule that creditors are per se interested and thus barred from employment by § 327(a). . . .");

39. See In re Martin, 817 F.2d 175, 181 (1st Cir. 1987) ("[Section] 327(a) will not support, either by its terms or by its objectives, a bright-line rule precluding an attorney at all times and under all circumstances from taking a security interest to safeguard the payment of his fees."); In re Palumbo Family Ltd. Partnership, 182 B.R. 447, 466 (Bankr. E.D. Va. 1995) (declining to follow decisions upholding a per se rule for disqualification and instead applying a “fact-intensive inquiry into the situation presented”); In re Gilmore, 127 B.R. 406, 409 (Bankr. M.D. Tenn. 1991) (rejecting the per se rule and declaring that a “[c]ourt should examine the circumstances of each case to determine if the security interest in favor of the attorney is necessary or is overreaching by the attorney”); In re Federated Dep’t Stores, Inc., 114 B.R. 501, 504 (Bankr. S.D. Ohio 1990) (rejecting a literal interpretation of § 327(a) and applying a balancing test weighing “the risk and gravity of the potential conflict of interest with the costs that the estate and perhaps the public would incur in the event of disqualification of the professional”); see also Lillian E. Kraemer, Ethical Issues Involving Case Professionals and Other Court-Appointed Parties in Chapter 11 Proceedings, C946 ALI-ABA 1, 17-18 (Sept. 29, 1994) (providing a discussion of In re Federated Dep’t Stores, Inc., 114 B.R. 501).


41. See id. Rule 2014, entitled: "Employment of Professional Persons" provides:

(a) APPLICATION FOR AN ORDER OF EMPLOYMENT. An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to § 327, § 1103, or § 1114 of the Code shall be made only on application of the trustee or committee. The application shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States trustee. The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant’s knowledge, all of the person’s connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. The application shall be accompanied by a verified
Partners Ltd. Partnership, a law firm did not disclose its increasing representation of a client to the court. The Granite court noted that in bankruptcy cases:

The scope of disclosure is much broader than the question of disqualification. ([A] court may find a disclosure violation even if the undisclosed connection does not amount to a conflict).

Rule 2014(a) does not expressly require supplemental or continuing disclosure. Nevertheless, section 327(a) implies a duty of continuing disclosure, and requires professionals to reveal connections that arise after their retention. ... [This] [c]ontinuing disclosure [requirement] is necessary to preserve the integrity of the bankruptcy system by ensuring that the trustee’s professionals remain conflict free.

Moreover, in In re Leslie Fay Cos., the court noted that proper disclosure allows the court to decide, in an informed manner, whether the retention should be approved. The professional must disclose all facts that bear on its disinterestedness. A failure to disclose undermines § 327 and the ability of the parties and the court to adequately review the retention of a professional.

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.

Id. at 538.

43. See id. at 28-29.
44. Id. at 35 (citations omitted).
46. See id. at 533 (“The purpose of Rule 2014 ... is to provide the court (and the United States Trustee) with information necessary to determine whether the professional’s employment meets the broad test of being in the best interest of the estate.” (quoting 8 L. King, COLLIER ON BANKRUPTCY, 2014.03 (15th ed.)). “Because the court was not armed with the facts, there was no meaningful opportunity provided for the court to determine whether to approve or disapprove [the law firm]’s retention.” Id. at 538.
47. See id. at 533.
B. Historical Background—Purpose of Disinterestedness Standard

Although a disinterestedness standard already existed in the original Bankruptcy Act of 1898, its application to the debtor-in-possession in the current Act of 1978 has been drawn into question. Chapter X, entitled “Corporate Reorganizations,” of the 1898 Act provided in § 156 that “[a]ny trustee appointed under this chapter shall be disinterested . . . .” Section 157 further stated that “[a]n attorney appointed to represent a trustee under this chapter shall also be a disinterested person . . . .” It has been pointed out that the managers of the estate under the 1898 Act had to be disinterested because Chapter X required the removal of the old debtor management. It therefore seemed only logical that the counsel of the disinterested manager should also be disinterested. Since § 1107(b) of the current 1978 Act provides that the manager of the estate does not always have to be disinterested, the application of the disinterestedness standard in the old Chapter X to the retention of professionals by the debtor-in-possession has been questioned. Critics of the disinterestedness standard point out that its application to debtors-in-possession was an unintended result, which may be traced back to drafting errors in § 1107(b). In order to further support this argument, one critic has pointed out that “significant change in reorganization practice was neither contemplated by the Commission on the Bankruptcy Laws of the United States nor discussed in the five years of Congressional hearings leading to the 1978 enactment of the Bank-
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rruptcy Code." This assertion appears to be supported by the Congres-
sional debates. During the debates regarding Bankruptcy Law Revi-
sions, a question was raised concerning the capacity of a debtor-in-
possession in a case under Chapter 11 to retain an attorney who worked
for the debtor before the case was filed. This question was answered by
Congressman Butler with the following response:

On its face, section 1107 appears to subject a debtor-in-possession to
the provisions of section 327(a) which require an attorney to be a
"disinterested person" as defined in section 101(13). This would ap-
pear to preclude an attorney for the debtor from serving as an attorney
for the debtor-in-possession. This is not the intent.

Section 330, [dealing] with compensation of officers, clearly dis-
tinguishes the debtor's attorney from other professional persons em-
ployed under section 327. The disqualifying language of section
328(c) should not apply to deny compensation to an attorney for the
debtor-in-possession solely because of his prior service as attorney for
the debtor. That is simply not the kind of direct or indirect relationship
intended to abrogate the standard of disinterestedness under section
101(13)(E).

Thus, the Congressional Record seems to support the position that the
disinterestedness standard, as formulated under the original Bankruptcy
Code of 1898 and applied to professionals employed by the trustee, was
not intended to be extended to the counsel for the debtor-in-possession.

Nevertheless, supporters of the rigid anti-conflict rule, as applied to
the trustee and the debtor-in-possession, point out that both owe fiduci-
ary obligations to the estate and to the creditors. Moreover, since many
parties in a bankruptcy proceeding are not represented, they are depend-
ent upon the integrity of the process which is to protect their interests.
Congressional Records indicate that major revisions of the 1898 Act
were necessary, because the public had lost confidence in the integrity
and fairness of the bankruptcy system due to widespread misconduct
among the ranks of bankruptcy professionals. The Commission on the

58. Smith, supra note 34, at 331.
60. See id.
61. Id.
62. See Warner, supra note 32, at 429.
63. See id.
see also Panel Discussion, supra note 34, at 206 ("One of the motivations for adopting the Bank-
rruptcy Code was this public perception that there was misconduct in the professional ranks of the

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Bankruptcy Laws of the United States, which was established by Congress in 1970 to analyze and evaluate changes in the original Bankruptcy Act, commented on the referee’s dual role as follows:

[M]aking an individual[, the bankruptcy judge,] responsible for conduct of both administrative and judicial aspects of a bankruptcy case is incompatible with the proper performance of the judicial function. Even if a paragon of integrity were sitting on the bench and could keep his mind and feelings insulated from influences which arise from his previous official connections with the case before him and with one of the parties to it, he probably could not dispel the appearance of a relationship which might compromise his judicial objectivity.5

As a result of the referee’s multiple and conflicting duties, the early bankruptcy system was viewed by many as an unfair forum.6 This sentiment of public mistrust was further warranted by an investigation in 1929 of the Southern District of New York, which revealed “serious abuses and malpractices on the part of attorneys, receivers, trustees, appraisers, custodians, auctioneers, and other persons and associations.”67 Although the investigation was launched in New York City, the Report found that “fundamental defects in administration are not restricted to New York, but exist generally throughout the country.”68

With this historical background in mind, it is not surprising that the drafters of the 1978 Act emphasized that reforms were aimed at establishing a bankruptcy forum that was fair not only in fact but in appearance as well.69 “As the Commission Report states, ‘[t]here must always be vigilance to ensure that the public has confidence in the bankruptcy system’s fairness and that it is operating to the public benefit, not just to

bankruptcy practice.”).

enrich debtors and their professionals.'"\(^7\) More specifically, with respect to the disinterestedness standard, the Commission Report explains that "'[s]trict disinterestedness standards are necessary because of the unique pressures inherent in the bankruptcy process.'"\(^7\) Thus, supporters of the disinterestedness standard maintain that the additional requirement is necessary to remind professionals employed by the trustee, as well as for the debtor-in-possession, that a fiduciary obligation is imposed upon them and that interests other than their own must be protected.\(^7\) As Judge Clevert, formerly a Bankruptcy Judge in the Eastern District of Wisconsin, and now a district court judge there, noted during a panel discussion:

> We don't want something to come out of the woodwork that might color the way in which that professional provides advice. Furthermore, we don't want the product of any reorganization to be one that the public, which does have an impact on the judicial process, will frown upon out of a sense that everyone was a bit too cozy.\(^7\)

### IV. APPLICATION TO THE HYPOTHETICAL

With § 327's historical background in mind, let us return to our hypothetical. As to the retention of the attorney's law firm by Blue Company under § 327:

1) Does the attorney or her firm hold or represent an interest adverse to the estate?

2) Are she and her firm disinterested?

Hold an interest adverse to—it seems that this is just another way of saying conflict of interest. And if it were, should not the result of the conflict of interest analysis be the same as it was when the attorney's retention was considered in the non-bankruptcy context?

In the non-bankruptcy analysis, there were two parties involved; full disclosure and consent resolved any conflict. Does that work here? Probably not. Remember, in pre-bankruptcy no one questioned the in-

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71. Id. (quoting Comm'n Report, supra note 70, at 874) (alteration in original).
72. See id. at n.31 (citing Comm'n Report, supra note 70, at 874-75).
73. Panel Discussion, supra note 34, at 204.
Our focus was on Blue Bank and Green Company. In bankruptcy, however, the estate’s interests need to be considered.

When considering the estate’s interests, does the fact that the attorney is a creditor mean that she holds an interest adverse to the estate? It depends on the size of the creditor body and the outstanding liabilities. It also depends on how this amount compares with the other outstanding receivables she may have as an attorney. In all, she must consider factors that were not considered previously. As to her stock interest, here too creditors may be concerned that she may jeopardize their interests to protect her equity. Furthermore, as far as being an officer, this raises issues as to the attorney’s possible involvement in decision-making, and the fact that her advice may be influenced by her desire to protect herself from blame for the financial condition of the debtor. As to the guaranty, the issue of divided loyalty is raised, but again it is not just between Green Company and its principal—this time it involves all creditors. In the end, the issue of disinterestedness will be raised and a balancing will take place. Included in this test will be the appearance of impropriety. Now we are in the bankruptcy fish bowl. The system is not only considering the interests of the parties but how does the bankruptcy system appear—will it appear fair? Does consent resolve these issues?

Assume there is a retention hearing and no one objects. Is that consent by all the parties?

What would happen if the attorney were to obtain a written waiver from all the parties? A waiver may be sufficient. However, assume for the moment that after review of all the facts, all the attorney’s connections are so de minimus that she could be found not to have had an adverse interest to the estate.

At this point, the court must consider whether the attorney meets the disinterestedness prong of § 327(a). 11 U.S.C. § 101(14) states that a disinterested person:

(A) is not a creditor, an equity security holder, or an insider; (B) is not and was not an investment banker for any outstanding security of the debtor; (C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor; (D) is not and was not, within two years before the date of the filing of the petition, a director,

74. See supra note 22.
75. See Warner, supra note 32, at 429.
officer, or employee of the debtor or of an investment banker specified in subparagraph (B) or (C). 76

"[S]ubsection (E), which is a "catch-all" provision," 77 generally disqualifies anyone with "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 an investment banker . . . or for any other reason." 78

As to subsection (A) it is clear that she does not qualify. She is a creditor, equity holder, and insider. Can it be cured?

She could waive her claim as a creditor. She could divest herself as an equity holder. As to her insider status as an officer, she could resign.

Subsections (B) and (C) do not apply. However, as to subsection (D), she has been an officer within the last two years, and it would seem that this cannot be cured. Although the attorney can resign to solve the problem under (A), it does not resolve the problem under (D).

As to subsection (E), to the extent the adverse interest prong of § 327 was met, this subsection really considers the same factors. Although its wording is broader, in that it addresses a materially adverse interest not only to the estate, but to creditors and equity security holders, from a practical standpoint, it is virtually the same analysis.

Now where does the attorney stand in her retention? It would seem that the disinterested requirement of § 327 is not met, and she cannot be retained to handle the bankruptcy proceeding of Blue Company.

Does this make sense? Why not use a balancing test, considering the interests of all the parties and if there are no objections, allow the retention?

Certainly this would be the response of many practitioners and some judges. However, in light of the history of bankruptcy law and its concern for the appearance of fairness in the process, 79 it seems to me that the rigid requirements of disinterestedness are necessary even though one could strongly argue that there should be a de minimus exception. To an extent, I could accept that premise, but I believe that such an exception would have to be carefully worded to prevent any abuse.
V. CONCLUSION

Both a state’s ethical requirements and § 327 apply in each bankruptcy case. It seems to me that when you examine the concerns of the New York Code and § 327 of the Bankruptcy Code the ethical issues are the same. What differs in bankruptcy though, is that these issues must be viewed in a much broader context; that being the interests of the estate and each class of creditors and equity holders. The issues of waiver and consent are far more difficult to address and in fact may not even apply in certain circumstances.

80. See id. at 430.