THE REVIEW OF
BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

Vol. 39 No. 8 August 2023

DETERMINING AND MANAGING CONFLICTS OF INTEREST IN BANKRUPTCY CASES

This article offers a summary of the conflict of interest and disclosure requirements for estate professionals under the Bankruptcy Code, provides an overview of recent court actions to punish counsel for actual conflicts of interest and failures to disclose, and offers guidance on best practices to avoid conflicts of interest in your next bankruptcy estate representation.

By Sarah L. Primrose and Brooke L. Bean *

It is exciting to bring in a new bankruptcy representation. Attorneys must, however, bear in mind the requirements of the Bankruptcy Code, including ethical rules regarding retention, disclosures, and conflicts of interest. By getting in front of these issues, attorneys can avoid costly sanctions, reputational damage, and fee disgorgement. The first section of this article summarizes applicable statutes and the Federal Rules of Bankruptcy Procedure — highlighting disclosure requirements for any estate professional. The second section provides a sampling of recent case law regarding conflicts of interest in bankruptcy cases, while the third section offers tips for avoiding conflicts of interest and disclosing potential conflicts as they arise.

CONFLICTS OF INTEREST AND DISCLOSURE REQUIREMENTS

Section 327(a) of the Bankruptcy Code, among others, governs the retention of estate professionals, including legal counsel and most financial consultants. Under section 327(a), an estate may retain and compensate an attorney, accountant, or other professional so long as such professional does "not hold or represent an interest *adverse* to the estate" and such professional is a "disinterested person[]."[1]

The Bankruptcy Code does not define an "adverse" interest, so case law shapes the definition. Courts differ, however, as to the exact test or standard to be applied. Many courts, including the Second Circuit, apply the test initially set forth in *In re Roberts*, which provides that an adverse interest is one where (1) the possession or assertion of any economic interest that would tend to decrease the value of the bankruptcy estate or create an actual or potential dispute with the estate as a rival claimant or (2) a predisposition of bias against the estate.[2] Courts within the Third Circuit tend to focus on

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[1] 11 U.S.C. § 327(a).

[2] *In re Roberts,* 46 B.R. 815, 826-27 (Bankr. Utah 1985); *see also In re Level 8 Apparel LLC*, 2023 Bankr. LEXIS 1006, *17-18 (Bankr. S.D.N.Y. April 13, 2023) (an "interest adverse to the estate" means "either (1) to possess or assert any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in

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actual, as opposed to potential or speculative, conflicts of interest.[3]

In contrast to the statutory lacuna surrounding "adverse interests," the Bankruptcy Code offers a detailed definition of a "disinterested person." Section 101(14) of the Bankruptcy Code provides that a "disinterested person" is one "that (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."[4] Courts have generally interpreted subsection (C) to require a *present* interest that is materially adverse — a prior or hypothetical interest is insufficient.[5] The most common example of a professional running afoul of the disinterestedness requirement in section 327(a) is one who is owed fees or expenses for pre-petition work, which makes the professional a creditor of the estate and thereby creates a violation of the disinterestedness requirement in section 327(a).[6]

There are certain narrow exceptions to the strict disinterestedness requirement in section 327(a). Specifically, section 327(c) of the Bankruptcy Code allows a debtor to retain a professional that is also representing a creditor provided (1) no creditor nor the United States Trustee objects to the retention or (2) if a party objects, no *actual* conflict of interest exists.[7] While courts differ in their interpretation of an "actual conflict" under section 327(c), one prevailing school of thought is that an "actual conflict" only exists under section 327(c) if there is "an active competition between two interests, in which one interest can only be served at the expense of the other."[8] While a *potential* conflict of interest is generally sufficient to warrant disqualification under section 327(a), that is not the case under section 327(c). Section 327(e) also contains certain exceptions for special counsel that should be explored, as applicable.

While the Bankruptcy Code provides the statutory requirements for the retention of estate professionals, Federal Rules of Bankruptcy Procedure Rule 2014 sets out the retention process. Rule 2014(a) provides that estate professionals must file an application requesting the bankruptcy court to approve the professional's retention. Among other things, the application must include "a verified statement of the [professional's] connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the

footnote continued from previous page…

which the estate is a rival claimant or (2) to possess a predisposition under circumstances that render such a bias against the estate"); *In re Granite Partners, L.P.*, 219 B.R. 22, 33 (S.D.N.Y. 1998) (same); *In re Hutch Holdings, Inc.*, 532 B.R. 866, 876 (Bankr. S.D. Ga. 2015) (same).

[3] *In re Boy Scouts of America*, 630 B.R. 122, 130 (D. Del. 2021) (an interest is adverse if a professional "holds or represents interests in competition with the debtor that would actually (as opposed to speculatively) impair its service as an estate fiduciary") (citing *In re First Jersey Sec., Inc.*, 180 F.3d 504, 509 (3d Cir. 1999)); *see also In re Vascular Access Ctrs., L.P.*, 613 B.R. 613, 624 (Bankr. E.D. Pa. 2020) (quoting *In re First Jersey Sec., Inc.*, 180 F.3d 504, 509 (3d Cir. 1999) (section "327(a) 'mandates disqualification when there is an actual conflict of interest, allows for it when there is a potential conflict, and precludes it based solely on an appearance of conflict'")).

[4] 11 U.S.C. § 101(14).

[5] *In re Persaud*, 496 B.R. 667, 677 (E.D.N.Y. 2013).

[6] *In re Owens*, 2014 WL 3867535, *4 (B.A.P. 9th Cir. Aug. 6, 2014) (affirming the bankruptcy court's holding that debtor's counsel was not disinterested for purposes of section 327(a) because it held a claim for pre-petition fees).

[7] 11 U.S.C. §327(c); *see also In re Decade, S.A.C., LLC*, 2020 WL 564903, *8 (Bankr. D. Del. Feb. 5, 2020) ("Bankruptcy Code itself clarifies that a professional is not disqualified from employment solely because the professional represents the trustee and a creditor").

[8] *In re Relativity Media, LLC*, 2018 WL 3769967, *2 (Bankr. S.D.N.Y. July 6, 2018) (citing *In re Empire State Conglomerates, Inc.*, 546 B.R. 306, 315 (Bankr. S.D.N.Y. 2016)).

United States Trustee, or any person employed by the United States Trustee."[9]

Courts interpret the disclosure requirements under Rule 2014(a) extremely broadly, consistently holding that *all* connections or potential conflicts must be disclosed even if, in the professional's opinion, they do not constitute a disqualifying conflict of interest under section 327(a) of the Bankruptcy Code.[10] In fact, the obligation to disclose *all* connections under Rule 2014 is not dependent on whether a professional would be disqualified under section 327 of the Bankruptcy Code for such connection. The mere failure to make the requisite disclosures can result in disqualification, sanctions, or disgorgement of fees — even if there are no disqualifying connections.[11]

Furthermore, while not directly stated in the language of Rule 2014(a), the rule's disclosure obligation is a continuing obligation that persists throughout the life of the bankruptcy case.[12] Simply put, there is a zero-tolerance policy among bankruptcy courts for an estate professional's failure to disclose.

CASE STUDIES

The following cases provide a sample of recent ethical issues considered by courts arising from retention and disclosure pleadings:

In re Vascular Access Ctrs., L.P., *613 B.R. 613 (Bankr. E.D. Pa. 2020)*

In *Vascular Access*, a law firm sought to represent a limited partnership debtor. Prior to the representation of the debtor, however, the law firm briefly represented and entered into an engagement letter with the debtor's general partner. The law firm failed to disclose the prior representation of the general partner, which was raised by the United States Trustee.

While the court did not find the conflict of interest to be disqualifying under section 327(a) of the Bankruptcy Code, the failure to disclose the connection was a "flagrant violation" of Rule 2014(a), and the delayed disclosure resulting from the United States Trustee's objection was insufficient to remedy the violation. As a result, the bankruptcy court sanctioned the law firm by denying its fees and costs before the date of the delayed disclosure. In determining the appropriate relief, the bankruptcy court expressed its intent to deter the law firm from committing the same "flagrant violation" in the future.

Additionally, this case highlights the risk of disqualification following acceptance of payment that constitutes a preferential transfer. The court found that the law firm's early application of its retainer during the preference period could constitute an avoidable preferential transfer because the law firm typically billed through monthly invoices. Therefore, the application of its retainer was not a payment in the ordinary course of business. Nevertheless, the court declined to avoid the transfers because of the new value and contemporaneous exchange for new value defenses.

The takeaways are clear — (1) even in the absence of a disqualifying conflict, an estate professional's failure to make the proper disclosures has serious consequences, including loss or disgorgement of fees and expenses, and (2) be cognizant of falling victim to a preferential transfer. Remember, it is not up to the professional to determine whether connections are irrelevant or trivial. Disclosure is the safest course of action.

In re SAS AB, 645 B.R. 37 *(Bankr. S.D. N.Y. 2022)*

In *SAS AB*, the debtors attempted to retain Skandinaviska Enskilda Banken AB ("SEB") as a co-investment bank. The United States Trustee objected on the basis that SEB was not "disinterested" because family members of the chairman of SEB's board of directors were associated with various non-profit foundations that owned 3.42% of the debtors' outstanding common stock. The value of the holding

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[9] Fed. Rules Bankr. Proc. Rule 2014(a).

[10] *In re Vascular Access Ctrs., L.P.*, 613 B.R. at 625 ("[a]ll facts that *may* be pertinent to a court's determination of whether an attorney is disinterested or holds an adverse interest to the estate must be disclosed"); *KLG Gates LLP v. Brown*, 506 B.R. 177, 193 (E.D.N.Y. 2014) ("[t]he decision as to what information to disclose should not be left to counsel, whose judgment may be clouded by the benefits of the potential employment").

[11] *In re Vascular Access Ctrs., L.P.*, 613 B.R. at 623; *In re Nilhan Developers, LLC*, 2021 WL 1539354, *15 (Bankr. N.D. Ga. April 19, 2021); *In re US Bentonite, Inc.*, 536 B.R. 948, 957-58 (Bankr. D. Wy. 2015).

[12] *In re Bay Voltex Corp.*, 2008 WL 8444794, *8 (B.A.P. 9th Cir. October 9, 2008) ("Rule 2014 has been interpreted to impose an ongoing duty to update information as circumstances change"); *In re NIR West Coast, Inc.*, 638 B.R. 441, 449-450 (Bankr. E.D. Cal. 2022); *In re ESJ Towers, Inc.*, 2022 WL 7721668, *6 (Bankr. D. P.R. October 13, 2022) ("Although [Rule] 2014 does not require continuous disclosure, courts have interpreted that the professional has the self-imposed obligation to continuously update and fully disclose to the court whether there are any circumstances which might suggest either an actual or potential conflict").

was approximately $13.2 million, compared to the family foundations' total assets of $24.3 billion. While the trustee argued that this information had not been disclosed, the court found evidence that the debtors had alerted the trustee of the relationship shortly after the retention application was filed and prior to the deadline for objections.

In approving SEB's employment over the trustee's objection, the bankruptcy court noted that the purpose of the disclosure requirements — "to enable parties to evaluate possible disqualifying interests" — was served by the debtors' timely disclosure to the trustee, thereby giving the trustee time to file an objection. Additionally, the connections between SEB, its chairman, and the foundation were not "materially adverse," nor did they give rise to a conflict of interest, as it was "only through strained speculation that a potential issue [could] even be posited."

This case serves as a reminder that (1) timely disclosures, even when made informally, are important in protecting the estate professional's retention and the integrity of the process and (2) many courts require conflicts of interest to be *actual* and *material* in order to warrant disqualification.

In re Chris Pettit & Assocs., P.C.*, 2022 WL 17723920 (W.D. Tex. Dec. 13, 2022)*

In *Chris Pettit*, the law firm of Martin & Drought, P.C. ("M&D") was hired to represent the debtors (an individual, Mr. Pettit, and his law firm). However, M&D previously represented Mr. Pettit in certain state court actions whereby he and his law firm were accused of a host of bad acts, including fraud, conversion, breach of fiduciary duty, felony theft, fraudulent inducement, and unjust enrichment — resulting in agreed judgments in excess of $35 million.

In its retention application, M&D stated that it merely provided pre-petition legal services to the debtor that were unrelated to the bankruptcy preparation or planning. They failed to mention that the prior representation was in connection with various state court proceedings in which creditors were seeking debt recovery. After the court's approval of the retention application, the debtor filed amended schedules and statements that contained pre-petition payments to M&D in the amount of $70,000 in connection with "several State Court Cases between March - June 2022." The United States Trustee objected, arguing that the law firm failed to sufficiently disclose its connections with the debtors because the disclosures did not include the fee structure and nature of its prepetition compensation. Moreover, the trustee argued that M&D had actual knowledge of the debtors' professional misconduct based upon the agreed judgments.

The court held that the M&D's disclosures were "unclear at best" and "illustrate the pattern of incomplete disclosures." The failure to disclose was compounded by M&D's alleged knowledge that monies used to pay its fees were funds of Mr. Pettit's law firm's clients, as the court had made clear an attorney's duty to investigate the source of the funds when it is reasonable to do so. Accordingly, the court denied the firm's fee applications and ordered that M&D disgorge all amounts received to the chapter 11 trustee to be held for the benefit of creditors.

As this case highlights, partial disclosure is insufficient to satisfy the requirements under the Bankruptcy Code and Federal Rules of Bankruptcy Procedure. Bankruptcy Courts strictly enforce a professional's obligation to disclose *all* connections and will not turn a blind eye to the failure to do so.

BEST CONFLICT PRACTICES

1. Thoroughly Investigate Potential Conflicts

It is important for professionals to have an organized way of determining and reviewing conflicts. You can be penalized for what you don't know. Professionals should be thorough in reviewing conflict reports and consider indirect, affiliate, and subsidiary relationships.

2. Disclose, Disclose, Disclose (again…)

Estate professionals should carefully consider *all* connections prior to filing a retention application and ensure that *all* connections are adequately disclosed. As noted above, this requires the professional to generate a thorough conflict report, including all connections with disclosure required under Rule 2014. The conflicts report should be reviewed carefully — any *present* connection identified therein, no matter the significance, should be disclosed to the court.

Additionally, while it is necessary to comply with the disclosure obligations in an initial retention application, the estate professional's job is not complete. Estate professionals should make it a habit to run updated conflicts reports throughout the lifespan of a bankruptcy case and examine each such report with the same rigor afforded to the initial retention application. To the extent any additional "connections" arise, the estate

professional should promptly update the bankruptcy court and the other parties in interest through a supplemental declaration or filing.

The case law is clear — failure to disclose even a *de minimis* connection may not only result in sanctions and disgorgement of the professional's fees, but also disqualification notwithstanding that no actual conflict of interest exists that justifies such an action. Therefore, it is imperative that estate professionals devote time and effort to the disclosure process and comply with Rule 2014 in all respects.

3. Pay Prepetition Balance in Advance of Filing

As briefly mentioned above, the most common violation of section 327(a) of the Bankruptcy Code occurs when an estate professional holds a claim for pre-petition expenses, making them a creditor of the debtor. In order to avoid that situation, estate professionals should ensure that all pre-petition invoices are paid prior to filing and such professional is holding unused portions of their retainer on the petition date.

Additionally, professionals should continue to adhere to their typical billing practices immediately prior to filing to avoid a preferential transfer. The avoidance of fees because of a preferential transfer can be a path to disqualification of the professional.

CONCLUSION

Estate professionals must understand the conflict and disclosure requirements under the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure. Failure to do so may result in disqualification or the disgorgement/loss of fees. By incorporating certain best practices into the conflicts process, professionals can limit the likelihood of becoming embroiled in a fight for retention or battle to keep hard-earned fees. ■