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Conflicts Issues in Representation of Debtors, Committees, and Creditors under State Ethics Rules and the Bankruptcy Code

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1. Bankruptcy Code requirements for debtors' counsel

1.1 Section 327 of the Bankruptcy Code

Section 327 of the Bankruptcy Code provides that debtors may employ attorneys that (a) do not hold or represent an adverse interest to the estate, and (b) are disinterested persons. The term "adverse interest" is not defined in the Code, and courts have applied various definitions. Most courts look to the motivation of debtor's counsel to act. *See, e.g. In re Martin*, 817 F.2d 175, 179 (1st Cir. 1987) (asking whether debtors' counsel possesses "a meaningful incentive to act contrary to the interests of the estate and its sundry creditors"); *In re Consolidated Bancshares, Inc.*, 785 F.2d 1249, 1256 (5th Cir. 1986) (adverse interest is one that "may engender conflicting loyalties"). The Third Circuit has adopted a rule that distinguishes between potential and actual conflicts: (1) where an actual conflict exists the attorney should be *per se* disqualified (2) where a potential conflict exists, the court has discretion to disqualify the attorney; and (3) disqualification is improper for mere appearance of a conflict. *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 476 (3d Cir. 1998).

However, some courts have found that there is no such thing as a benign "potential" conflict and have rejected the potential/actual dichotomy. *See In re Kendavis Indus. Int'l, Inc.*, 91 B.R. 742, 753 (Bankr. N.D. Tex. 1988) ("the concept of potential conflicts is a contradiction in terms. Once there is a conflict, it is actual—not potential."). The *Kendavis* court held that where an attorney agrees to protect the interests of management, a shareholder, or any control person of the debtor, the attorney has an actual conflict which requires disqualification.

Disinterestedness is defined in section 101(14) as a person that (a) is not a creditor, an equity security holder, or an insider; (b) is not and was not, within 2 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 interests of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason. 11 U.S.C. § 101(14). One issue that occasionally arises is whether counsel seeking to be employed under section 327(a) may be employed if it holds a prepetition claim and is thus a creditor. Most courts considering this issue have held that attorneys with prepetition claims are prohibited from being employed as professionals because they are not disinterested. *E.g.*, *In re Pierce*, 8089 F.2d 1356, 1362-63 (8th Cir. 1987); *In re E. Charter Tours, Inc.*, 167 B.R. 995, 996 (Bankr. M.D. Ga. 1994) However, some courts have read section 1107, which provides that previous employment does not disqualify a professional from employment under section 327 solely because it represented the debtor pre-petition, to permit employment of counsel with a pre-petition claim against the estate. *E.g.*, *In re SBMC Healthcare, LLC*, 473 B.R. 871 (Bankr. S.D. Tex. 2012); *In re Talsma*, 436 B.R. 908 (Bankr. N.D. Tex. 2010).

Because directors and officers are considered insiders under section 101(31), the statute appears to disqualify them from acting as professionals. Sometimes, however, in other contexts, courts have been asked to consider whether an officer is really an insider. While titles generally control, some courts have looked beyond the title at whether the officer exhibited control. *Compare Brandt v. Tablet Divito & Rothstein, LLC (In re Longview Aluminum LLC)*, 419 B.R. 351, 355 (Bankr. N.D. Ill. 2009) (under section 101(31) of the Code, "directors" or "officers" of

a corporation are insiders regardless of ability to control the corporation) with *In re Foothills Texas, Inc.*, 408 B.R. 573, 585 (Bankr. D. Del. 2009) (title of "vice president" creates a presumption that the person is an officer which can be rebutted by a showing that the person did not participate in active management of the debtor) and *In re NMI Sys. Inc.,* 179 B.R. 357, 370 (Bankr. D.D.C. 1995) (defining an officer as any person who has "undue influence over the debtor's actions").

Finally, section 101(14)(c) contains what is known as the "catch-all" provision, defining an insider as 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 . . ." The Third Circuit has stated that this provision is intended to encompass anyone who "in the slightest degree might have some interest or relationship that would even faintly color the independent and impartial attitude required of an attorney or debtor professional." *In re BH&P Inc.*, 949 F.2d 1300, 1308 (3d Cir. 1991). Other courts have adopted similar definitions. *See Kravit, Gass & Weber, S.C. v. Michel (In re Crivello)*, 134 F.3d 831 (7th Cir. 1998); *In re Kobe Real Estate, LLC*, 2011 Bankr. LEXIS 3266 at *16 (Bankr. S.D.C. Aug. 31, 2011).

1.2 Representing multiple debtors in jointly administered case

As any chapter 11 practitioner will recognize, affiliated debtors often have intercompany loans or financial arrangements that give rise to claims by and against affiliated debtors. Can the same attorney represent debtors that have claims against each other? Many courts adopt a "wait and see" fact-based approach to determine the extent to which additional professionals are necessary in cases where individual debtors have claims against one another. The rationale for this approach is that a per se rule requiring appointment of independent professionals to represent each individual debtor in all cases where there are intercompany claims would burden estates with insurmountable administrative expenses. *In re Adelphia Communs. Corp.*, 342 B.R. 122, 128 (S.D.N.Y. 2006); s*ee also In re BH&P Inc.*, 949 F.2d at 1322; *In re Rentfrew Ctr., Inc.*, 195 B.R. 335, 342 (Bankr. E.D. Pa. 1996); *In re Mulberry Phosphates, Inc.*, 142 B.R. 997, 998 (Bankr. M.D. Fla. 1992); *In re Global Marine, Inc.*, 108 B.R. 998, 1002 (Bankr. S.D. Tex. 1987); *In re Guy Masonry Contractor*, 45 B.R. 160, 166 (Bankr. D. Ariz. 1984); *In re Int'l Oil Co.*, 427 F.2d 186, 198 (2d Cir. 1970).

While many courts have found joint representation of affiliated debtors with intercompany claims is permissible, unusual or egregious facts may require retention of separate counsel. For example, in *Quarles & Brady, LLP v. Maxfield (In re Jennings)*, 199 Fed. Appx. 845 (11th Cir. 2006), a law firm was disqualified from serving as counsel to eleven affiliated debtors where one of the debtors depleted its assets despite another debtor's secured claim against those assets. In *In re JMK Constr. Group, Ltd.*, 441 B.R. 222 (Bankr. S.D.N.Y. 2010), four related debtors sought to retain the same counsel. A judgment had been entered against the debtors in an unrelated proceeding, which resulted in the debtors having rights of contribution among one another. *See id.* at 225. The debtors also had intercompany claims with each other. *Id.* at 227. The court held that the contribution and intercompany claims prohibited joint representation by the same lawyer under section 327(a). *Id.* at 233-37. It may be that anything more than garden-variety intercompany claims will result in the need for separate counsel.

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