

**CONFLICTS OF INTEREST : COMMON PROBLEMS FACING PROFESSIONALS
REPRESENTING DEBTORS AND TRUSTEES IN THE CARIBBEAN**

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I. The General Standards For Employment of Professionals Under the Bankruptcy Code

- A. Attorneys and other Professionals that perform services for a Trustee must meet the twin standards of “disinterestedness” and no “interest adverse to the estate” pursuant to 11 U.S.C. Section 327 (a). In addition, Section 327(c) provides that a professional will not be disqualified solely because of “such person’s employment by or representation of a creditor”, although upon objection by creditor or the United States Trustee, the court “shall” disapprove the employment if there is an “actual conflict of interest”. The same standards apply to professionals employed by a debtor in possession.
- B. The definition of a “disinterested person” is set forth in 11 U.S.C. Section 101 (14), as a person that (A) “is not a creditor”, (B) “ is not and was not within 2 years” before the petition date, “ a director, officer or employee of the debtor”, or (C) does not have an interest that is “materially adverse”. (Also see 11 U.S.C. Section 1107(b), which states that a person is not disqualified under 327(a) from employment by a debtor in possession “solely because of such person’s employment by or representation of the debtor before the commencement of the case”.)
- C. Many courts have concluded that the requirements of Section 327(a) are stricter from the standards applicable to attorneys outside of bankruptcy under the ABA Model Rules of Professional Conduct. *See, e.g., In re Federated Department Stores, Inc.*, 44 F. 3d 1310(6th Cir. 1995); *In re McKinney Ranch Assocs.*, 62 B.R. 249, 254 (Bankr. C.D.Cal. 1986); *but see, In re Wheatfield Business Park*, 286 B.R. 412 (Bankr. C.D.Cal. 2002) (discussed below). Concepts of consent and waiver are often more difficult to apply in the context of an attorney that represents a debtor in possession, since the debtor is deemed to be acting as a fiduciary for the entire creditor body. A conflict that runs afoul of Section 327 (a) generally cannot be waived by a debtor in possession or trustee, regardless of whether all parties consent.
- D. The duty to disclose and remain disinterested is continuing. Section 328(c) provides a penalty for professional persons found to be under a conflict of interest. It provides, in relevant part:

[T]he court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under section 327 or 1103 of this title if, at any time during such professional person's employment

under section 327 or 1103 of this title, such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed.

- E. Outside of bankruptcy, conflicts arising from representation of clients that may have adverse interests are governed by Model Rule 1.7 (setting forth the limits on the representation of two clients with adverse interests at the same time, even in an unrelated matter, and providing for the ability to waive certain conflicts if both clients consent after full disclosure); and Rule 1.9 (setting forth the limits on the representation of a client with interests materially adverse to a former client in a substantially related matter, and the ability to obtain a waiver if the both clients consent after full disclosure.) There are no provisions in the Bankruptcy Code for a waiver of the requirements of Section 327(a). Moreover, Section 327(a) applies not only to attorneys, but any professional employed by a debtor or a trustee.
- F. There is a more flexible standard in 11 U.S.C. Section 327(e) allowing for employment by of an attorney that has previously represented the debtor “for a specified special purpose” and not as general counsel. This provision is often used to continue the employment of an attorney in ongoing litigation, or to pursue an adversary proceeding, where the debtor of the trustee has retained separate counsel to act in all other matters.

II. Common Conflicts: (1) Representation of the Debtor and Its Principal; and/or (2) Current or Prior Representation of a Creditor in an Unrelated Matter

- A. Most corporate debtors in the Virgin Islands (and no doubt many in Puerto Rico as well) are non public, closely held corporations run by one or two shareholders, who also serve as officers and directors. Often the shareholders have personally guaranteed debts owed by the corporation to its major lender. Outside of bankruptcy, it is not uncommon for the same lawyer or firm to represent and advise both the corporation and the officers/shareholders on non-litigation matters, or even in litigation where their interests are not adverse. If a corporation and its shareholder, officers or director are sued, Model Rule 1.7 allows for joint representation even in the face of a potential conflict, if all of the clients consent after full disclosure. Two of the most common conflicts that arise in small or large jurisdictions, but particularly in smaller jurisdictions like Puerto Rico and the Virgin Islands, are: (1) the representation of a closely held corporation or a partnership and its officers/principal shareholders or partners; and (2) the representation of a debtor or a trustee by an attorney or a firm that has some current or prior relationship with a creditor of the estate. The former almost always results in disqualification. The latter depends on the particular facts. Conflicts can also arise, however, from less obvious connections between an attorney or law firm and any other party that may have an interest adverse to the Estate. The cases discussed below illustrate what can happen to professionals

that fail to appreciate and/or fully disclose such conflicts.

1. The Third Circuit addressed the prohibition against simultaneous representation of the debtor and a shareholder or officer of the corporation in In re BH&P, Inc., 949 F.2d 1300 (3d Cir. 1991). Where there is an actual conflict, there seems to be agreement by courts that have considered the issues that disqualification pursuant to Section 327 is mandatory. While there is some discretion in the case of a “potential conflict”, even where the conflict is remote and the reasons for employment are “particularly compelling”, employment of a professional with a potential conflict is “disfavored.” BH&P, 949 F 2d at 1316-1317. In BH&P, a corporation and both of its principal shareholders filed for bankruptcy. The case were consolidated and a singly trustee and law firm were appointed to represent all 3 estates. On the motion of a creditor, the district court disqualified the trustee and the law firm from serving the shareholders’ estates and the Third Circuit affirmed.
2. BH&P applies with equal force to the more common situation where a lawyer is acting as counsel for the debtor in possession, and of necessity is in close contact with the officers that are still running the business. It is often difficult for the Debtor’s principals to appreciate that the Debtor—and Debtor’s counsel—must act the interests of the Estate and all its creditors even if that means taking a position that might not be in the best interest of the shareholders and/or the officers. The attorney must be careful and especially diligent in explaining to the officer or shareholder that he or she now represents a fiduciary known as the debtor in possession and must act in the best interest of all creditors, even when this may not be consistent with the personal interests of the officers/shareholders. Whenever a shareholder is a guarantor, or a creditor (because of shareholder loans) that individual should be strongly encouraged to retain separate counsel.
3. In re Marvel Entertainment Group, Inc., 140 F. 3d 463 (3d Cir. 1998) arose on appeal from the district court’s ruling that carried the mandate of BH&P one step further. The district court denied the trustee’s application to approve the employment of his law firm based the firm’s *prior* representation of a creditor in an unrelated matter. The creditor had given an unqualified waiver of any conflict, and the firm and the creditor had mutually terminated their relationship. The district court nonetheless held that the prior relationship might “faintly color the independence and impartial attitude “of the firm. The Third Circuit revisited BH&P and clarified its prior holding that an actual conflict results in per se disqualification, and a potential conflict may result in disqualification, depending on the remoteness of the conflict and the reasons why the employment may otherwise be beneficial, a decision committed to the bankruptcy court’s sound discretion. The Third Circuit held that the

district court's disqualification, which was based solely upon an appearance of impropriety, was wrong and reversed. It could be dangerous, however, to read Marvel too expansively. In Marvel, the firm had completely terminated its relationship with the creditor. The court was not faced with a case where a professional employed by the debtor continued to represent a creditor, even in an unrelated matter.

4. In re Ponce Marine Farm Inc., 259 B.R. 484 (D.P.R. 2001) dealt with the consequences failure to promptly disclose a potential conflict that developed after debtors' counsel was retained. At the time that the employment of debtors' counsel was approved, the debtors were in lawsuits that had been pending for several years. Two matters were settled by assigning or selling claims and interests to Martech Enterprises L.C. and motions were filed to approve the settlements. Several months after the settlements were approved, the United States Trustee was advised that lead counsel's father and brother were investors in Martech; a connection that had never been disclosed. By then, the representation had ceased. The U.S. Trustee filed an objection to the professional's application for compensation contending that the family connection was a conflict of interest that should be sanctioned by the denial of fees. The bankruptcy court determined that there was no actual conflict, that counsel zealously represented the debtors and that his efforts had benefited the estate. Nonetheless, because the potential conflict should have been disclosed, the court denied compensation for the period after which the disclosure should have been made. The U.S. Trustee appealed, contending that Rome v Braunstein, 19 F. 3d 54, 58 (1st Cir. 1994) mandated denial of all fees. The district court distinguished Rome, noting that the attorney's representation in that case produced virtually no benefit and that the conflict was "patently in appropriate". The district agreed with the bankruptcy court that neither Section 328 (c) nor Rome mandated denial of all fees.

III. Waivers And Consents in the Bankruptcy Context

- A. There is no guarantee that client waivers and consents will be enforceable in bankruptcy cases; indeed, one court has stated that "certain conflicts that a client could waive after full disclosure outside of the bankruptcy context, such as simultaneous representation of the client and the client's creditor, are prohibited by the Bankruptcy Code itself from being waived." In re American Energy Trading Inc., 291 B.R. 154 (Bankr. W.D. Mo. 2003).
- B. Consents may be enforceable in the bankruptcy context, or may at least be considered to be evidence that no disabling conflict exists. In re Head, 110 B.R. 621 (Bankr, M.D. Ga. 1990). Consent has been allowed provided that all creditors are notified and given an opportunity to be heard; and provided that the notice

provides adequate information about the propose joint representation and the known potential conflicts of interest. In re Wheatfield Bus. Park, LLC, 286 B.R. 412, 420-21 (Bankr. C.D. Cal. 2002)

IV. The Professional As Creditor

- A. The courts are not in agreement over whether a professional who is also a creditor must be disqualified from retention by the estate. Some courts find that they are required to disqualify the professional, but other courts conclude that they have discretion in these matters.
- B. The Court of Appeals for the Third Circuit has interpreted section 101 literally and rejected the employment of the debtor's prepetition accountants who held a substantial claim against the estate. The court expressly rejected the argument that bankruptcy courts are authorized to take a flexible approach in determining disinterestedness of a professional pursuant to section 327(a). United States Trustee v. Price Waterhouse, 19 F.3d 138, 30 C.B.C.2d 1522 (3d Cir. 1994). This per se rule has been applied to disqualify counsel that received a preferential payment in the form of a stock transfer in payment for pre-petition legal work. In re First Jersey Securities, Inc., 180 F. 3d 504 (3d Cir. 1999) (a preferential transfer creates an actual conflict of interest for which disqualification is mandatory). In In re Pillowtex, Inc., 304 F. 3d 246 (3d Cir. 2002), the Court held that the existence of a potential preference had to be resolved before counsel's employment could be approved. Debtors's counsel, Jones Day, explained that it sought payment from Pillowtex of its outstanding bills in order that it would not be a creditor at the time of the bankruptcy, as that would have disqualified it from retention as counsel. Jones Day contended that a hearing on the potential preference claim would be expensive and unnecessary, any possible conflict could be avoided by authorizing the retention subject to the conditions that (1) Jones Day return any preference it is determined to have received, and (2) Jones Day waive any claim resulting from the preference. The Third Circuit rejected this approach, holding that in the face of a plausible claim of a substantial preference, the court was not free to avoid the clear mandate of Section 101 by leaving the preference issue for another day.
- C. The First Circuit has rejected a per se disqualification rule for attorneys who were creditors of the debtor's estate, in favor of a case-by-case test to determine whether the attorney's interestedness resulted in any "meaningful incentive" to behave contrary to the interests of the estate and its creditors. In re Martin, 817 F.2d 175, 183 (1st Cir. 1987). In Martin the issue was whether it was permissible for debtor's counsel to take a mortgage in the debtor's real estate as security. The First Circuit held that "[i]t is for the court to decide whether the attorney's proposed interest carries with it a sufficient threat of material adversity to warrant prophylactic action (say, disqualification or disgorgement or invalidation of a

lien). Sincerity or protestations of good faith, no matter how genuine, will not be enough. The test must be more an objective one.” *Id.*, at 182. The Court explained that the inquiry “is of necessity case-specific”. It is axiomatic that full and timely disclosure must be made of the details of any given arrangement.

V. Related Issues

- A. Disclosures of the source for payment of fees. 11 U.S.C. Section 329 and Bankruptcy Rule 2016. Payment by a shareholder or sister corporation may be approved, if, but only if, there is adequate disclosure.
- B. Prohibitions against fee splitting. Rule 2016.