

Is Proving Disinterestedness Enough?

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Bankruptcy professionals are well-acquainted with the disinterestedness concept. In most instances, disinterestedness is easily established and work proceeds. But where disinterestedness is challenged, a significant legal battle can ensue. Is it enough to win that battle?

Suppose the affected professional defends a challenge to his disinterestedness and the bankruptcy court rules that the professional is indeed disinterested. An order is entered, work proceeds, fees are expected and all is well – or is it? What happens if the employment order establishing disinterestedness is appealed? Putting aside (for purposes of this paper) whether the order is final, and assuming appellate review will proceed (in some jurisdictions, an employment order is final and appealable; in others, an interlocutory appeal might be allowed), what happens if the disinterestedness determination is reversed and the appellate court finds the professional actually never was disinterested? Worse, what if that fearsome ruling occurs a year later? In most cases, a lot of work will have been performed and significant fees probably will have accrued (to say nothing of costs that will have been advanced out of the professional's own pocket).

Assuming that the employment order was not stayed, can you at least be paid for work performed under its auspices? In the Ninth Circuit, most likely you can be paid for services rendered up to the time the employment order is reversed. Indeed you may be able to establish the mootness of the appeal and avoid having the disinterestedness ruling reviewed at all. However, in the Sixth Circuit, the professional may face the unholy

prospect of losing all rights to be paid, putting great strain on the professional and the case, any time there is an appeal of an employment order – even if the employment is not stayed.

A. Ninth Circuit

In two cases, the Ninth Circuit and the Ninth Circuit Bankruptcy Appellate Panel have issued rulings that seem to effectively mean that if a professional establishes his disinterestedness, he need not fear losing the foundation of his right to be paid under that order, so long as the order is not stayed (we do not here refer to reasonableness of compensation issues). In *In re CIC Investment Corp.*, 192 B.R. 549 (BAP 9th Cir 1996) (CIC II), the scenario summarized above unfolded. A law firm for a debtor-in-possession filed an employment application and disinterestedness was challenged. The professional (and his client) prevailed, an employment order was entered and work proceeded.

A creditor appealed the employment order and a few months later the disinterestedness ruling was reversed. *See In re CIC Investment Corp.*, 175 B.R. 52 (BAP 9th Cir. 1994) (CIC I). Meanwhile, counsel prosecuted a fee application relative to the period of the employment order's vitality. Fees were awarded and the creditor appealed again. In CIC II, the BAP refused to order disgorgement of fees earned prior to the time the employment order was reversed, notwithstanding the absence of original disinterestedness, finding that a valid court order existed while the work was being performed and the underlying disinterestedness question was at least unsettled until the time the employment order was vacated. 192 B.R. at 553.

Four years later, a similar series of events unfolded in the *S.S. Retail* case. In *In re S.S. Retail Stores Corp.*, 216 F.3d 882 (9th Cir. 2000), disinterestedness was again

challenged and the professional prevailed in the bankruptcy court. On appeal to the BAP, the ruling was sustained. The first appeal did not reach the Ninth Circuit because the employment order was not final. *See In re S.S. Retail Stores Corp.*, 162 F.3d 1230 (9th Cir. 1998). Undeterred, the U.S. Trustee renewed the appeal when the case reached closure, after the affected law firm had been paid interim fees and sought approval of its final fee application.

Going further than the BAP did in CIC II, the Ninth Circuit would not hear the challenge to disinterestedness at all. Even though the court found the appeal was not equitably moot because effective relief could be afforded in the form of a disgorgement order, the court still found that "the equities weigh[ed] in favor of dismissing the appeal." 216 F.3d at 885. Among the "numerous factors" weighing against any disgorgement order, apparently as a matter of law, the court found that the law firm had always fully disclosed the circumstances, the lawyer who bore the "interest" never worked on the case, no objection to competency or quality of work was raised and no stay was obtained. *Id.*

“The rule the U.S. Trustee would have us adopt would be harsh and would create a difficult ethical dilemma for counsel. It would require a law firm to abandon its client whenever the U.S. Trustee objected to its employment, even though that employment had the blessing of two [unstayed] orders...” *Id.*

B. Sixth Circuit

Under the *CIC* and *S.S. Retail* cases, practitioners in the Ninth Circuit seem safe once they prevail on the disinterestedness issue in the bankruptcy (trial) court. Not so in the Sixth Circuit. In the *Federated Stores* case, a scenario similar to the one in *S.S. Retail*

occurred. When the appeal reached the circuit court, the debtor and the professional moved to dismiss on grounds of mootness because the professional's work had been concluded and was no longer employed. The Sixth Circuit refused, holding that the validity of the employment order was not moot because it had "collateral consequences" on the fee-allowance order. *In re Federated Dept. Stores, Inc.*, 44 F.3d 1310, 1316-17 (6th Cir. 1995).

The Sixth Circuit went on to specifically hold that "[w]e find no basis for [the professional] to claim that equity requires dismissal of this appeal," since the professional knew of the continuing objection and elected to continue working anyway. 44 F.3d at 1317. While the professional in that case was allowed partial fees, calculated to an intervening date on which a prior decision should have made it clear that the professional was not disinterested, the Sixth Circuit also pointed out that the partial compensation scenario would not repeat because the law was settled. *Id.* at 1320.

The Sixth Circuit thus holds professionals to a "you knew what might happen" and "you knew what the risks were" standard – not a good result for the professional and, for reasons observed in *S.S. Retail*, not a good result for clients, whose selected professional may be gunshy about working, even after prevailing in an employment battle. This seems particularly unfair and unwise as a matter of policy, where the question was not even close enough to merit a stay pending appeal (or if the appellant did not even seek one, making the squeeze play even harsher).

C. When Policies Collide

These cases present a difficult collision of important principles. On the one hand, it is difficult to argue that a professional who was never disinterested should be paid for

work he could never rightly be authorized to perform. On the other hand, good-faith reliance on an unstayed court order, together with the policy of maintaining real distinctions between stayed and unstayed orders, seems to be more than a reasonable way to harmonize the realities that disinterestedness is often not a crystal clear concept, court orders mean what they say and considerable work is required of able professionals in the period over which even expedited appellate review extends. Should practitioners in the Sixth Circuit, and anywhere else where the courts might agree with the Sixth Circuit, who prevail in a disinterestedness battle resign as soon as the U.S. Trustee or a creditor appeals an employment order, or even merely announces that it will do so when it becomes final, where the order is not stayed? The opportunity for abuse is obvious and perhaps future cases will give the Sixth Circuit an opportunity to eliminate the harshness lurking in *Federated*.