THE CONTINUING LACK OF GUIDANCE ON PROFESSIONAL RETENTION IN BANKRUPTCY AND ITS POTENTIAL IMPACT ON CORPORATE DEBTORS' RETENTION OF ADEQUATE LEGAL COUNSEL

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This Article analyzes the continuing uncertainty surrounding the requirements of the Bankruptcy Code and state ethical codes with respect to a chapter 11 debtor's retention of legal counsel. The Article suggests that the current approach to the application of each set of rules is inconsistent and untenable, particularly with respect to large corporate debtors and the attorneys they have sought to retain. The Article also suggests that some of the inconsistency and confusion may arise from what Professor Ted Schneyer has described as the conflict between "internal" rules (such as state ethical codes) and "external" rules (such as the Bankruptcy Code). The Article then discusses several courses of action that have been suggested for remediating this uncertainty and looks to why those courses of action have not been taken.

INTRODUCTION

Representing a corporate debtor in a chapter 11 bankruptcy proceeding in its capacity as "debtor in possession"[1] presents an attorney with a maze of

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1. As discussed in greater detail below, there is a dispute regarding whether counsel retained by a "debtor in possession" represents the "debtor in possession" or the "estate." For simplicity, this Article refers to counsel for the "debtor in possession" in a chapter 11 proceeding as "Debtors' Counsel." *See infra* Part II.B.

intersecting rules and requirements that must be satisfied in order to obtain both the required court approval of the attorney's retention and payment.[2] Moreover, bankruptcy attorneys remain subject to the same body of state ethical rules governing the conduct of non-bankruptcy practitioners, and indeed bankruptcy courts may sanction counsel for violations of state ethics codes.[3] As a result, Debtors' Counsel must, at all times, satisfy the applicable requirements of both the Bankruptcy Code and the jurisdiction's ethical rules. Yet satisfying these rules is no easy task in light of the fact that significant uncertainties remain about how exactly the Bankruptcy Code interacts with state ethics codes and how strictly the various provisions of each should be applied in the unique context of representing a debtor in possession.

Many commentators have written about the daunting disconnect between the demands on Debtors' Counsel and the requirements of the Bankruptcy Code, the American Bar Association's Model Rules of Professional Conduct (the Model Rules), the American Bar Association's Model Code of Professional Responsibility (the Model Code), the ALI Restatement (Third) of the Law Governing Lawyers (the Restatement), and the state ethical codes based thereon—as well as the general lack of guidance from the Bankruptcy Code and Bankruptcy Rules regarding the proper interpretation and application of its requirements relating to professional retention.[4] Professor Schneyer has suggested that such

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2. Although representing an individual in bankruptcy proceedings may present similar and equally interesting problems, this Article primarily focuses on the representation of a corporate debtor. Similarly, many of the issues discussed herein may arise in the context of representing a receiver, trustee or corporation in chapter 7 proceedings. While such issues merit further attention and analysis, this Article will principally focus on the representation of a corporate debtor in proceedings arising under Chapter 11 of the United States Code and in its capacity as "debtor in possession."

3. *See* Century Indem. Co. v. Congoleum Corp. (*In re* Congoleum Corp.), 426 F.3d 675, 687 (3d Cir. 2005) ("Bankruptcy professionals are required to examine their relationship not only based on the two-party litigation model, but also one guided by 'a stricter, fiduciary standard.'") (citing 1 COLLIER ON BANKRUPTCY ¶ 8.01[1] (15th ed. 2005) [hereinafter COLLIER]); *In re* Creative Rest. Mgmt., Inc., 139 B.R. 902, 909 (Bankr. W.D. Mo. 1992) ("In order to determine whether a law firm should represent a Chapter 11 debtor, a two-step analysis is required. First, the law firm must determine whether it has a conflict of interest under applicable ethical rules governing the conduct of attorneys. Then, the Court must determine whether the Bankruptcy Code makes such firm ineligible due, for example, to its prior relationship to the debtor."); Susan Pierson Sonderby & Kathleen M. McGuire, *A Gray Area in the Law? Recent Developments Relating to Conflicts of Interest and the Retention of Attorneys in Bankruptcy Cases*, 105 COM. L.J. 237, 238 (2000) ("State rules of professional conduct apply in proceedings before federal bankruptcy courts."). Some courts have found that violation of the rules of professional conduct is sufficient to deny retention of an attorney. *See, e.g.*, *In re* Universal Bldg. Prods., No. 10-12453, 2010 WL 4642046, at *8 (Bankr. D. Del. Nov. 4, 2010) (denying retention of a counsel by the official committee of unsecured creditors where the firm had violated Model Rule 7.3, and the corresponding Delaware Rule of Professional Responsibility, by soliciting employment from creditors prior to formation of the committee); *In re* Soulisak, 227 B.R. 77, 80 (Bankr. E.D. Va. 1998). *But see In re* Vanderbilt Assocs., Ltd., 117 B.R. 678, 680 (D. Utah 1990).

4. Ted Schneyer, *How Things Have Changed: Contrasting the Regulatory Environments of the Canons and the Model Rules*, 2008 J. PROF. LAW. 161, 179 (2008).

issues can be described as a conflict between "internal" rules (the state ethical codes) and "external" rules (the Bankruptcy Code) and that these types of conflicts are increasingly prevalent in modern legal practice. In the context of commercial bankruptcies, in which there are often thousands of potential parties in interest, the issues stemming from the lack of guidance on such issues are even more acute and problematic.[5]

Over the past several decades, particularly in the late 1990s, a broad spectrum of changes have been suggested that could potentially remediate, or at least lessen the impact, of this problem, and provide guidance on how exactly Debtors' Counsel should proceed in the face of such issues. Unfortunately, these proposals appear to have been largely ignored. Neither the Model Rules, the Model Code, nor the Restatement provide any specific guidance on how these issues should be approached, and the Bankruptcy Code and the Bankruptcy Rules have not been altered to provide any additional guidance.[6]

This continuing lack of clarity is troubling, particularly as the size of both corporate debtors and the firms that represent them have steadily grown over the past decade. The risk of sanctions for Debtors' Counsel who breach state ethical codes during the course of a representation is quite real, although perhaps less common than the denial or disgorgement of fees or the denial of a retention application as a result of a failure to satisfy the requirements of the Bankruptcy Code.[7] Yet, despite these serious risks for lawyers, their firms, and the corporate debtors they represent, the hodgepodge of case law interpreting the legal grounds for such sanctions, denial of retention, and fee disgorgements provides little definitive guidance.

Perhaps more troubling is the possibility that if both the rules and requirements of the Bankruptcy Code and the rules and requirements of state ethical codes were consistently applied strictly to Debtors' Counsel, then most large corporate chapter 11 debtors might be unable to retain legal professionals with the resources and sophistication that are required to service fully their legal needs. Perhaps to compensate for this risk, the rules and requirements of the Bankruptcy Code and the state ethical codes do not appear to be consistently applied in a strict manner to the retention of Debtors' Counsel. Rather, they are applied in a piecemeal fashion that presents Debtors' Counsel with relatively little guidance for how complex ethical issues should be appropriately addressed. In the

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5. *See* Nancy B. Rapoport, *The Intractable Problem of Bankruptcy Ethics: Square Peg, Round Hole*, 30 HOFSTRA L. REV. 977, 985 (2002) [hereinafter Rapoport, *Square Peg, Round Hole*].

6. The American Law Institute has historically determined that the best course of dealing with these issues is to completely avoid them, and determined to take this course of action in the Restatement of the Law Governing Lawyers. *See* Charles W. Wolfram, *The Boiling Pot of Lawyer Conflicts in Bankruptcy*, 18 MISS. C. L. REV. 383, 383 (1998). For further analysis of this decision, see *infra* Part IV.

7. For examples of disqualification based on state ethical code violations, see *In re* Universal Bldg. Prods., 2010 WL 4642046, at *8; McGill v. Capozzoli (*In re* Berger McGill, Inc.), 242 B.R. 413, 423 (Bankr. S.D. Ohio 1999), *In re* RKC Dev. Corp., 205 B.R. 869, 873–74 (Bankr. S.D. Ohio 1997), and *In re* Sauer, 191 B.R. 402, 407 (Bankr. D. Neb. 1995).

words of one commentator, "[j]udicial decisions on the subject [of lawyer conflicts in bankruptcy] sometimes reflect what may charitably be characterized as chaos."[8] Ultimately, "[t]he Bankruptcy Code provides inconsistent, incoherent, and incomplete guidance as to when professionals may be employed."[9]

The result of the foregoing is that Debtors' Counsel for corporate debtors are often retained without complication, but periodically a Debtors' Counsel is severely punished for issues that are likely present in many large bankruptcy cases. This Article analyzes this dilemma and suggests that it is inherently untenable, particularly in the context of large corporate bankruptcies, where such issues are often unavoidable. Part I of this Article discusses the Bankruptcy Code provisions, and some of the case law relating thereto, that establish the requirements Debtors' Counsel must satisfy before a bankruptcy court may approve the retention and payment of Debtors' Counsel, as well as the consequences of violating these provisions. Part II then turns to the overlay and obstacles presented by state ethical codes that may impact retention of Debtors' Counsel. Part III discusses why the confusing and inconsistent application of the retention rules contained in the Bankruptcy Code and the requirements of state ethics codes are particularly problematic in the context of large corporate debtors. Finally, Part IV examines proposals for resolving the lack of clarity in both the Bankruptcy Code and the state ethical rules regarding the retention and payment of Debtors' Counsel, and the status of such proposals.

I. THE RULES AND REQUIREMENTS OF THE BANKRUPTCY CODE GOVERNING THE RETENTION OF DEBTORS' COUNSEL

Debtors' Counsel may only be retained after a retention application—accompanied by a sworn affidavit of the firm being retained—is approved by the bankruptcy court.[10] Section 327 of the Bankruptcy Code provides the starting point for any examination of professional retention under the Bankruptcy Code.[11] Section 327 provides that a debtor in possession may "employ one or more attorneys . . . 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 [debtor in possession's] duties under [the Bankruptcy Code]."[12] Thus, a

8. Wolfram, *supra* note 6, at 383.

9. Gerald K. Smith, *Standards for the Employment of Professionals in Bankruptcy Cases: A Response to Professor Zywicki's "Case for Retaining the Disinterestedness Requirement for Debtor in Possession's Professionals,"* 18 MISS. C. L. REV. 327, 335 (1998).

10. "The purpose of the retention application and accompanying affidavit is to insure that the services to be provided are necessary and that the person to be employed is disinterested and able to serve the best interests of the estate." William I. Kohn, Michael P. Shuster & Lee D. Powar, *Deciphering Conflicts of Interest in Bankruptcy Representation: An Update*, 105 COM. L.J. 95, 121–22 (2000).

11. *In re* Marvel Entm't Grp., Inc., 140 F.3d 463, 475 (3d Cir. 1998).

12. 11 U.S.C. § 327(a) (2006). Section 327 only refers to trustees. However, under § 1107 of the Bankruptcy Code, debtors in possession have all the rights and duties of a trustee. 11 U.S.C. § 1107 (2006). Thus, § 1107 permits a debtor in possession to employ its own attorney subject to the requirements of § 327 and with the bankruptcy court's approval. *See id.* Under 28 U.S.C. § 1334, the district court has exclusive jurisdiction over

bankruptcy court may only approve the retention of attorneys who (a) do not hold or represent an interest adverse to the estate, and (b) are "disinterested persons."[13] Compliance with the requirements of § 327(a) is required not only at the time of the retention of the professional, but throughout the course of the bankruptcy case.[14] "Courts . . . must take the requirements of section 327 seriously, as they ensure that a professional fulfills his duties in accordance with his fiduciary duties to the estate."[15] Indeed, the "requirements of section 327 cannot be taken lightly, for they 'serve the important policy of ensuring that all professionals appointed pursuant to [the section] tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities.'"[16]

Below, the two prongs of § 327 are discussed separately, although the prongs certainly overlap to an extent and some courts have observed that the two prongs truly "form one hallmark with which to evaluate whether professionals seeking court-approved retention (or to remain retained by the estate) meet the absence of adversity requirements embodied in the Bankruptcy Code."[17]

A. Prong 1—Holding or Representing an Interest Adverse to the Estate

Section 327 prohibits those who hold or represent interests adverse to the estate from being retained as Debtors' Counsel. "Adverse interest" is not defined by the Bankruptcy Code, nor is the phrase "hold or represent an interest adverse to the estate" defined or further explained by the Bankruptcy Code. Although this language is similar to that set forth in Model Rules 1.7 and 1.9 and the state ethical codes based thereon,[18] bankruptcy courts have varied widely in their application of the standard. The Second Circuit has set forth the following definition of the phrase:

> (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 which the estate is a rival claimant;

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all claims or causes of action involving construction of § 327 or rules relating to disclosure requirements thereunder, effectively requiring any claims against professionals for violations of such rules to be brought in front of the bankruptcy court. 28 U.S.C. § 1334(e)(2) (2006); *see also, e.g.*, *In re* WorldCom, Inc., 311 B.R. 151, 163 (Bankr. S.D.N.Y. 2004).

13. *In re* Am. Printers & Lithographers, Inc., 148 B.R. 862, 864 (Bankr. N.D. Ill. 1992) ("Professionals may only be employed to represent a debtor-in-possession if they are disinterested and they do not hold or represent any interest adverse to the estate while they are employed thereby.").

14. *In re* Vebeliunas, 231 B.R. 181, 187 (Bankr. S.D.N.Y. 1999).

15. *In re* Project Orange Assocs., LLC, 431 B.R. 363, 370 (Bankr. S.D.N.Y. 2010). The "fiduciary duties to the estate" are discussed in more detail in Part II below.

16. *In re* Leslie Fay Cos., 175 B.R. 525, 532 (Bankr. S.D.N.Y. 1994) (quoting Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir. 1994)); *see also* Sonderby & McGuire, *supra* note 3, at 245.

17. *In re Vebeliunas*, 231 B.R. at 189; *see also In re* Martin, 817 F.2d 175, 179 n.4 (1st Cir. 1987) (collecting cases).

18. *See In re* Granite Partners, L.P., 219 B.R. 22, 33–34 & nn.11–12 (Bankr. S.D.N.Y. 1998) (construing New York's disciplinary rules).

> or (2) to possess a predisposition under circumstances that render such a bias against the estate.[19]

Other courts have looked to the motivation of the Debtors' Counsel, asking whether the Debtors' Counsel possesses "a meaningful incentive to act contrary to the best interests of the estate and its sundry creditors."[20] Note that the adverse interest test "is not retrospective; courts only examine *present* interests when determining whether a party has an adverse interest."[21] However, this is not to say that events in the past cannot create an ongoing adverse interest. Moreover, because § 327(a) includes the "representation" of adverse interests as well as the holding of adverse interests, the representation of a creditor by the attorney *could* disqualify the attorney from retention under § 327(a).[22]

Ultimately, "[c]ourts determine whether an adverse interest exists on a case-by-case basis, examining the specific facts in a case."[23] Most courts have found that an adverse interest must rise to a certain degree of materiality before it disqualifies a professional representing a debtor in possession and that there is no per se disqualification under this prong of § 327.[24] For example, simultaneous representation of another party in interest in unrelated matters does not, per se, compel disqualification, but instead only requires disqualification when adverse interests either exist or are likely to develop.[25] This gives rise to a fact-specific inquiry into the exact nature of the adverse interest in order to determine the level of materiality.[26]

In analyzing the degree of materiality, several courts have attempted to distinguish between "actual" and "potential" conflicts.[27] Typically, conflicts that are contingent on future events that have a reasonable chance of occurring may

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19. Bank Brussels Lambert v. Coan (*In re* AroChem Corp.), 176 F.3d 610, 623 (2d Cir. 1999) (citations omitted); *see also In re* Caldor, Inc. NY, 193 B.R. 165, 171 (Bankr. S.D.N.Y. 1996); *In re* Am. Printers & Lithographers, Inc., 148 B.R. 862, 864 (Bankr. N.D. Ill. 1992).

20. *In re Martin*, 817 F.2d at 180; *see also In re* BH & P Inc., 949 F.2d 1300, 1309 (3d Cir. 1991); Pierce v. Aetna Life Ins. Co. (*In re* Pierce), 809 F.2d 1356, 1363 (8th Cir. 1987); Pierson & Gaylen v. Creel & Atwood (*In re* Consol. Bancshares, Inc.), 785 F.2d 1249, 1256 (5th Cir. 1986) (adverse interest is one that "may engender conflicting loyalties" (quoting 2 COLLIER, *supra* note 3, ¶ 327.03)).

21. *In re* Project Orange Assocs., LLC, 431 B.R. 363, 370 (Bankr. S.D.N.Y. 2010); *see also* Sonderby & McGuire, *supra* note 3, at 246.

22. *In re AroChem*, 176 F.3d at 620–24; *In re* Huntco Inc., 288 B.R. 229 (Bankr. E.D. Mo. 2002).

23. *In re Project Orange*, 431 B.R. at 370.

24. *See, e.g.*, U.S. Tr. v. First Jersey Sec., Inc. (*In re* First Jersey Sec., Inc.), 180 F.3d 504 (3d Cir. 1999).

25. *See, e.g.*, *In re* Jade Mgmt. Servs., 386 F. App'x 145, 149 (3d Cir. 2010); *In re* Plaza Hotel Corp., 111 B.R. 882, 890 (Bankr. E.D. Cal. 1990).

26. *See In re* Marvel Entm't Grp., Inc., 140 F.3d 463, 476 (3d Cir. 1998); *In re* Martin, 817 F.2d 175, 181–82 (1st Cir. 1987); Pierce v. Aetna Life Ins. Co. (*In re* Pierce), 809 F.2d 1356, 1363 (8th Cir. 1987); *In re* Creative Rest. Mgmt., Inc., 139 B.R. 902, 903 (Bankr. W.D. Mo. 1992).

27. *See, e.g.*, *In re* BH & P Inc., 949 F.2d 1300, 1314–17 (3d Cir. 1991); *In re* McKinney Ranch Assocs., 62 B.R. 249, 255 & n.7 (Bankr. C.D. Cal. 1986).

warrant disqualification, while more speculative conflicts will not.[28] As discussed in more detail in Part I.D below, the Third Circuit has established that there should be a per se disqualification for professionals with an actual conflict of interest, that courts should have discretion when there is only a potential conflict of interest, and that courts should not disqualify a professional merely based on the appearance of conflict.[29] This distinction is supported by § 327(c) of the Bankruptcy Code, which provides that:

> a person is not disqualified for employment under [§ 327] 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.[30]

However, as discussed below, some courts have found the distinction between potential and actual conflicts to be semantically problematic.[31]

B. Prong 2—The Disinterested Person

As with the adverse interest prong, "[c]ounsel's compliance with the disinterestedness requirements under § 327(a) not only applies at the time of retention but also throughout the case, and is so crucial to the proper functioning of the bankruptcy system that a court may raise it and dispose of it whenever its sanctity is questioned."[32] Yet, unlike the standard regarding adverse interest to the estate, the Bankruptcy Code defines "disinterested person" in § 101(14) of the Bankruptcy Code. Section 101(14) provides that:

> The term "disinterested person" means a person that –
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> (A) is not a creditor, an equity security holder, or an insider;
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> (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
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> (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.[33]

This short definition nevertheless gives rise to a number of complicated issues including: (a) how narrowly, or how broadly, the terms within § 101(14)(A)

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28. *See In re* O'Connor, 52 B.R. 892, 897 (Bankr. W.D. Okla. 1985); *In re* Stamford Color Photo, Inc., 98 B.R. 135, 138 (Bankr. D. Conn. 1989); *In re* Leslie Fay Cos., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994). *But see In re* Granite Partners, L.P., 219 B.R. 22, 38 (Bankr. S.D.N.Y. 1998).

29. *In re Marvel Entm't*, 140 F.3d at 476; *In re* Zenith Elec. Corp., 241 B.R. 92, 100 (Bankr. D. Del. 1999).

30. 11 U.S.C. § 327(c) (2006).

31. *See In re* Kendavis Indus. Int'l, Inc., 91 B.R. 742, 753–54 (Bankr. N.D. Tex. 1988).

32. *In re* Vebeliunas, 231 B.R. 181, 187 (Bankr. S.D.N.Y. 1999) (citations omitted).

33. 11 U.S.C. § 101(14) (2006).

and (B) should be interpreted; (b) what exactly § 101(14)(C) adds to the analysis that was not already captured within § 327; and (c) whether a lack of disinterestedness should be imputed from a single attorney to that attorney's law firm.

1. *Section 101(14)(A) and (B): Creditors, Equity Security Holders, Insiders, Directors, Officers, and Employees*

Section 101(14)(A) and (B) instructs that there are certain people that per se cannot be disinterested. Namely, these people are: creditors, equity security holders, insiders, and anybody who, within two years of the date on which the bankruptcy petition was filed, was a director, officer, or employee of the debtor. Some of these categories are fairly straightforward, and § 101 provides definitions for many of the terms. For example, a "creditor" is any:

> (A) entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor; (B) entity that has a claim against the estate of a kind specified in section 348(d), 502(f), 502(g), 502(h) or 502(i) of [the Bankruptcy Code]; or (C) entity that has a community claim.[34]

An "equity security holder" is a "holder of an equity security of the debtor."[35] There is no definition in the Bankruptcy Code for "employee," but this typically presents no issue for the retention of professionals as § 1107(b) provides that, notwithstanding the requirements of § 327, "a person is not disqualified for employment . . . solely because of such person's employment by or representation of the debtor before the commencement of the case."[36]

The remaining terms in § 101(14)(A) and (B) are trickier and their exact breadth less clear. "Insider" is a particularly problematic term. Indeed, "[e]xtreme complexity and considerable duplication result from the addition of 'insider' to the list of per se disqualifications resulting from the definition of disinterestedness."[37] Pursuant to § 101(31), an "insider" of a corporate debtor includes (but is not limited to) a "(i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor."[38] The Bankruptcy Code provides no definition

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34. *Id.* § 101(10).

35. *Id.* § 101(17).

36. 11 U.S.C. § 1107(b) (2006). Due to the interweaving nature of the Bankruptcy Code, if you are an officer or a director then you are actually not disinterested under both 101(14)(A) and 101(14)(B). Indeed, given § 1107(b)'s removal of "employee" as a disqualification, § 101(14)(B) really only adds to § 101(14) by capturing those individuals who were directors or officers within two years of the filing date, but were not directors or officers on the filing date.

37. Smith, *supra* note 9, at 336.

38. 11 U.S.C. § 101(31)(B). Note that this is a non-exhaustive list and thus courts are free to find additional people to be insiders: "The legislative history of §101(31)(B) states that 'an insider is one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms length with the debtor.'" J. Kate Stickles & Patrick J. Reilley, *Identifying Insiders for Purposes of*

for the terms "director," "officer," "person in control," or "general partner" and case law varies widely in interpreting these terms.

For example, one of the more expansive and inconsistently interpreted terms is that of "officer." In *In re NMI Systems, Inc*., an oft-cited case on the definition of officer, the court, in determining whether a vice president was an officer, found that an officer is any person who has "undue influence over the debtor's actions" and that this includes:

> those in the collective group exercising overall authority regarding the debtor's corporate decisions who, as members of that insider group, are in a position to exert undue influence over corporate decisions regarding payment of their claims in tight financial times including those who are privy to critical information regarding the debtor's financial stability and able to act to their advantage on the basis of such information.[39]

Several courts have followed the definition of "officer" in *NMI Systems*,[40] although recently the Bankruptcy Court for the District of Delaware split from this definition. In *In re Foothills Texas, Inc.*, the Bankruptcy Court for the District of Delaware found that, in determining whether a person is an officer, a title such as "vice president" creates a *presumption* that the person is an officer; this presumption can later be rebutted by a showing that such a person did not participate in the active management of the debtor.[41] Similarly, other courts have found that the level of control is actually irrelevant to whether one is a debtor or officer of the debtor and, as a result, an insider.[42] Thus, whether an individual is an "insider" (or was an "officer") and thus lacks the disinterestedness required by § 327 would depend, at least in part, on what role the individual holds or held at the debtor corporation within two years, what the individual's title was, what the individual's job duties were, and, perhaps most importantly, the jurisdiction in which the bankruptcy case is filed.

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§ 503(C), AM. BANKR. INST. J., Oct. 2009, at 28, 28 (quoting *In re* CEP Holdings LLC, Nos. 06-51847, 06-51848, 06-51849, 2006 WL 3422665, at *2 (Bankr. N.D. Ohio Nov. 28, 2006) (quoting S. REP. 95-989, at *25 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5810)).

39. 179 B.R. 357, 370 (Bankr. D.D.C. 1995).

40. *See, e.g.*, 455 CPW Assocs. v. Greater N.Y. Sav. Bank (*In re* 455 CPW Assocs.), No. 99-5068, 2000 U.S. App. LEXIS 23470, at *17–18 (2d Cir. Sept. 14, 2000).

41. 408 B.R. 573, 585 (Bankr. D. Del. 2009).

42. *See, e.g.*, *In re* Pillowtex, Inc., 304 F.3d 246 (3d Cir. 2002); Harold & Williams Dev. Co. v. U.S. Tr. (*In re* Harold & Willams Dev. Co.), 977 F.2d 906, 909 (4th Cir. 1992); Childress v. Middleton Arms, Ltd. P'ship (*In re* Middleton Arms, Ltd. P'ship), 934 F.2d 723, 725 (6th Cir. 1991); Pierce v. Aetna Life Ins. Co. (*In re* Pierce), 809 F.2d 1356 (8th Cir. 1987); U.S. Tr. v. Fieldstone Mort. Co., No. CCB-08-755, 2008 U.S. Dist. LEXIS 91479, at *15–16 (D. Md. Nov. 5, 2008); Smith v. Ruby (*In re* Pub. Access Technology.com, Inc.), 307 B.R. 500, 505 (E.D. Va. 2004); Magers v. Bonds (*In re* Bonds Distrib. Co.), No. 98-6044, 2000 Bankr. LEXIS 1964, at *10–14 (Bankr. M.D.N.C. Mar. 31, 2000); Brandt v. Tablet Divito & Rothstein, LLC (*In re* Longview Aluminum, LLC), 419 B.R. 351, 355 (Bankr. N.D. Ill. 2009) (stating that, under § 101(31), "directors" or "officers" of a corporation are insiders regardless of their ability to control the corporation); Bucki v. Singleton (*In re* Cardon Realty Co.), 146 B.R. 72, 78 (Bankr. W.D.N.Y. 1992).

Moreover, it is not just an individual's status that is important, but also the status of any of their "relatives" as well.[43] Under § 101(45), the term "relative" means "individual related by affinity or consanguinity within the third degree as determined by the common law, or individual in a step or adoptive relationship within such third degree." Thus, under the strict language of the Code, a professional would not be disinterested if a second cousin of the professional was a vice president of the debtor that asserted the requisite amount of control as determined by the law in the particular district in which the case is filed.

Adding further confusion, courts have disagreed regarding how strictly the per se rules of § 101(14) should be applied.[44] While many courts have found that a per se application of these per se rules is mandated by the statute, and therefore any lack of disinterestedness results in automatic disqualification of a Debtors' Counsel or other professional, other courts have found that bankruptcy courts have a certain degree of latitude to depart from the per se application of the statute by looking at the circumstances of each case.[45]

The rigidity with which the disinterested standard is applied also appears to vary based on which part of the disinterested test a proposed Debtors' Counsel fails. The majority of courts have found that where a professional is a prepetition creditor of the estate, the professional cannot be retained under the plain language of § 327 and § 101(14).[46] Other courts, though, have refused to apply a per se disqualification rule for attorneys who are creditors of the estate and have held that bankruptcy courts should inquire as to whether the professional's status as a creditor resulted in a "meaningful incentive" to act contrary to the best interests of the estate.[47] There tends to be a sharper division on whether professionals holding

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43. Bankruptcy Rule 5002 also provides that "[t]he employment of an individual as an attorney, accountant, appraiser, auctioneer, or other professional person pursuant to §§ 327, 1103, or 1114 shall not be approved by the court if the individual is a relative of the bankruptcy judge approving the employment." FED. R. BANKR. P. 5002(a).

44. Arthur J. Gonzalez, *Conflict of Interest and Other Ethical Issues Facing Bankruptcy Lawyers: Is Disinterestedness Necessary to Preserve the Integrity of the Bankruptcy System?*, 28 HOFSTRA L. REV. 67, 75–76 (1999).

45. *Compare* Pierson & Gaylen v. Creel & Atwood (*In re* Consol. Bancshares, Inc.), 785 F.2d 1249, 1256 (5th Cir. 1986), *In re* Envirodyne Indus., Inc., 150 B.R. 1008, 1017 (Bankr. N.D. Ill. 1993), *and In re* Am. Printers & Lithographers, Inc., 148 B.R. 862, 866 (Bankr. N.D. Ill. 1992), *with In re* Martin, 817 F.2d 175, 181–82 (1st Cir. 1987), and *In re* Pac. Express, Inc., 56 B.R. 859, 861 (Bankr. E.D. Cal. 1985).

46. *See generally In re* Pierce, 809 F.2d 1356 (8th Cir. 1987); *In re Pillowtex*, 304 F.3d at 253 n.5; *In re* Printcrafters, Inc., 208 B.R. 968, 977 (Bankr. D. Colo. 1997), *rev'd*, 233 B.R. 113 (D. Colo. 1999); *In re* Argus Grp. 1700, Inc., 199 B.R. 525, 529–30 (Bankr. E.D. Pa. 1996); *In re Middleton Arms*, 934 F.2d at 724; *In re* Jaimalito's Cantina Assoc. Ltd. P'ship, 114 B.R. 1, 1 (Bankr. D.D.C. 1990).

47. *In re Martin*, 817 F.2d at 180–81; *see also In re* Adam Furniture Indus., Inc., 158 B.R. 291, 297 (Bankr. S.D. Ga. 1993); Meeker v. Germeradd (*In re* Quincy Air Cargo, Inc.), 155 B.R. 193, 195–96 (Bankr. C.D. Ill. 1993); *In re* Gilmore, 127 B.R. 406, 408–09 (Bankr. M.D. Tenn. 1991). "The most common disinterestedness difficulties for professionals under 327(a) are (i) being characterized as a 'creditor' and (ii) being exposed as the recipient of a preferential payment." Michael R. Nestor, Edwin J. Harron, & Ian S. Fredericks, *Avoiding the Pitfalls in the Retention Process*, J. CORP. RENEWAL, Oct. 1, 1995, at 44. Debtors' Counsel generally avoid becoming a creditor of the estate by obtaining an

an equity interest should be per se disqualified, with some courts interpreting the rule literally[48] and others finding exceptions, particularly if the equity interest was *de minimis*.[49] Courts are even divided regarding whether a professional who is an insider should be automatically disqualified[50] or if a case-by-case approach should be taken.[51]

2. Section 101(14)(C)

Section 101(14)(C) has been referred to as a "catch-all" provision of the disinterestedness requirement. This section provides that in addition to the categories of individuals referenced in § 101(14)(A) and (B), professionals may also fail the disinterested test if they 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."[52] The Third Circuit has noted that the provision is intended to encompass anyone who "in the slightest degree might have some interest or relationship that would even faintly color the independence and impartial attitude required" of an attorney or other debtor professional.[53] Other courts have recognized that:

> the meaning of the phrase "interest materially adverse" in the definition of a disinterested person overlaps with that of "interest adverse" in the first prong of § 327(a) and, together, they form one hallmark with which to evaluate whether professionals seeking court-approved retention (or to remain retained by the estate) meet the absence of adversity requirements embodied in the Bankruptcy Code.[54]

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adequate retainer prior to beginning the representation and ensuring that the fees earned and expenses incurred do not exceed the amount of the retainer. *Id.* Even if the Debtors' Counsel is a creditor of the estate on the petition date, some courts and United States Trustees permit a Debtors' Counsel to remove this disqualifying interest by waiving the prepetition claim that the Debtors' Counsel holds as of the petition date.

48. *See* Michel v. Federated Dep't Stores, Inc. (*In re* Federated Dep't Stores, Inc.), 44 F.3d 1310, 1318 (6th Cir. 1995) (finding that a financial advisor that held debtors' securities was disqualified and strictly interpreting the disinterestedness requirements).

49. *See In re* O'Connor, 52 B.R. 892, 899 (Bankr. W.D. Okla. 1985).

50. Capen Wholesale, Inc. v. Michael (*In re* Capen Wholesale, Inc.), 184 B.R. 547, 549 (N.D. Ill. 1995); *In re* Yuba Westgold, Inc., 157 B.R. 869, 872 (Bankr. N.D. Iowa 1993); *In re* Tinley Plaza Assocs., L.P., 142 B.R. 272, 277 (Bankr. N.D. Ill. 1992).

51. Stanley v. Keravision, Inc. (*In re* Keravision, Inc.), 273 B.R. 614, 618–19 (N.D. Cal. 2002); *In re Adam Furniture*, 158 B.R. at 298; *In re* GHR Energy Corp., 60 B.R. 52, 65 (Bankr. S.D. Tex. 1985); *In re* Pac. Express, Inc., 56 B.R. 859, 862 (Bankr. E.D. Cal. 1985).

52. 3 COLLIER, *supra* note 3, ¶ 327.04[2][a][i](B); *see also In re* Granite Partners, L.P., 219 B.R. 22, 32 (Bankr. S.D.N.Y. 1998).

53. *In re* BH & P Inc., 949 F.2d 1300 (3d Cir. 1991) (citation and internal quotation marks omitted); *see also In re* Crivello, 194 B.R. 463, 465 (E.D. Wis. 1997), *rev'd*, 134 F.3d 831 (7th Cir. 1998).

54. *In re* Vebeliunas, 231 B.R. 181, 189 (Bankr. S.D.N.Y. 1999) (citations omitted); *see also* Smith v. Marshall (*In re* Hot Tin Roof, Inc.), 205 B.R. 1000, 1002–03

Generally, the analysis most courts have followed with respect to § 101(14)(C) closely parallels the "adverse interest" prong of § 327(a), and often the circumstances captured by the sections appear to be largely similar. However, occasionally courts have applied § 101(14)(C) to disqualify professionals that would not otherwise be disqualified by the "adverse interest" prong. For example, in *In re Vebeliunas*, the Bankruptcy Court for the Southern District of New York reasoned that the "or for any other reason" language in § 101(14)(C) permitted the bankruptcy court broad discretion to find a lack of disinterestedness in circumstances other than those spelled out in § 101(14), and indeed allowed a bankruptcy court to "reject an attorney if it 'deems a particular person's associations to be prejudicial to disinterestedness . . . even though those associations do not come within the purview of [§ 101(14)].'"[55]

3. *Imputing a Lack of Disinterestedness from a Single Attorney to the Attorney's Firm*

Given the prohibition on retaining an attorney who is not properly disinterested, an additional issue arises regarding whether a law firm can be retained if an individual member of that firm is not disinterested. For example, what if an attorney in a large law firm is an "officer" of a debtor under the relevant case law in the jurisdiction in which the case is to be filed, but that partner will not play a part in the representation of the debtor? Should the partner's lack of disinterestedness prohibit the firm as a whole from being retained? Courts confronted with this question have disagreed on the proper resolution.

In an early case addressing the issue of imputing a lack of disinterestedness, the Bankruptcy Court for the District of Connecticut found that a lack of disinterestedness by a single partner in a law firm prohibited the firm from being retained under § 327(a) of the Bankruptcy Code.[56] The facts of the case are relatively simple. Prior to the bankruptcy, for approximately sixteen years, the law firm seeking retention had acted as the debtor's general counsel, and during the course of that representation an "of counsel" of the firm, F. Van Siclen Parr, served as both a director and an officer of the debtor, and a partner, James H. Bell, served as an officer.[57] Both Parr and Bell resigned their positions prior to the bankruptcy filing but not outside the two year time frame established by § 101(14).[58] The firm asserted, among other things, that the lack of disinterestedness of Parr and Bell should not be attributed to the firm.[59] The bankruptcy court rejected this argument, finding that "[i]t is not uncommon for attorneys to be indirectly disqualified from representing a client when they are associated with

(B.A.P. 1st Cir. 1997); *In re Granite Partners*, 219 B.R. at 33; *In re* Leslie Fay Cos., 175 B.R. 525, 532 (Bankr. S.D.N.Y. 1994); *In re* Envirodyne Indus., Inc., 150 B.R. 1008, 1017 (Bankr. N.D. Ill. 1993).

55. *In re Vebeliunas*, 231 B.R. at 191 (quoting 1 COLLIER BANKRUPTCY MANUAL ¶ 101.13 (3d ed. 1981)) (disqualifying a trustee's proposed counsel as a result of bias against the debtor).

56. *In re* Wells Benrus Corp., 48 B.R. 196, 198 (Bankr. D. Conn. 1985).

57. *Id.* at 197–98.

58. *Id.* at 198.

59. *Id.*

other attorneys who are directly disqualified."[60] In support of this proposition, the court relied on Disciplinary Rule 5-105(D) of the Model Code of Professional Responsibility, which provided: "If a lawyer is required to decline employment or to withdraw from employment under any Disciplinary Rule, no partner or associate or any other lawyer affiliated with him or his firm may accept or continue such employment."[61] The court concluded that as a result, "[t]he disqualification of any attorney pursuant to Code § 327(a) causes every other attorney in that attorney's firm to be disqualified as well."[62]

Several courts followed the opinion in *In re Wells Benrus Corp*., often by citing to or explicitly relying on the rules of professional conduct in the district. For example, in *In re Tinley Plaza Associates, L.P.*, the court found that "if an attorney who is a member of a law firm is disqualified from employment by the debtor-in-possession because he or she does not meet [the adverse interest and disinterested person requirements under § 327], then all the members of the attorney's law firm are also disqualified."[63] The court reached this conclusion by relying on Rule 1.10(a) of the Rules of Professional Conduct for the Northern District of Illinois, which prohibited a lawyer associated with a firm from representing a client when another lawyer in the firm would be prohibited from doing so under the Rules of Professional Conduct for the Northern District of Illinois.[64] Subsequent courts have relied on these holdings to also find that the lack of disinterested status of a single partner in a firm disqualifies the firm from retention under § 327.[65]

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60. *Id.*

61. *Id.* at 198–99 & n.5.

62. *Id.* at 199 (citation omitted).

63. 142 B.R. 272, 277 (Bankr. N.D. Ill. 1992).

64. *Id.*; *see also In re* Phila. Athletic Club, Inc., 20 B.R. 328, 338 n.11 (E.D. Pa. 1982) (relying on applicable ethics code to find that when an attorney is required to withdraw as counsel to trustee, his firm cannot continue to be employed by trustee); *In re* Envirodyne Indus., Inc., 150 B.R. 1008, 1017–18 & n.11 (Bankr. N.D. Ill. 1993) (citing to applicable state ethics code to support statement that if one attorney in firm is disqualified from representing debtor, the entire firm is disqualified); Stanley v. Krogstad (*In re* Petro-Serve Ltd.), 97 B.R. 856, 861 (Bankr. S.D. Miss. 1989).

65. *See, e.g.*, *In re* ZB Surfside Co., No. 93-B-44875, 1994 Bankr. LEXIS 1852, at *23–26 (Bankr. S.D.N.Y. Nov. 30, 1994). The issue of imputation of disinterestedness arises most often in the context of retaining a law firm. Some have argued that because many of the opinions upholding the imputation of disinterestedness rely on the professional conduct rules governing attorneys, there is no basis for imputing lack of disinterestedness when evaluating a potential § 327 retention of other professional organizations that are not governed by similar rules, such as investment banks. *See* Kurt F. Gwynne, *Employment of Turnaround Management Companies, "Disinterestedness" Under the Bankruptcy Code, and Issues Under Delaware General Corporation Law*, 10 AM. BANKR. INST. L. REV. 673, 699 (2002); C.R. "Chip" Bowles, *A Weird New World: Disinterestedness for Investment Bankers Under New 11 U.S.C. § 101(14)*, AM. BANKR. INST. J., Feb. 2006, at 26. However, in *In re United Color Press, Inc.* 129 B.R. 143, 146–47 (Bankr. S.D. Ohio 1991), the court found that a consulting firm was not a "disinterested person" because one of its employees, a vice president, had served and was serving as an officer of the Debtor. As a result, the court in *United Color Press* found that the consulting firm could not be retained under § 327. Additionally, in *In re Capitol Metals Co.*, 228 B.R. 724 (B.A.P. 9th Cir. 1998), the

The reliance on the state ethical codes to determine whether a lack of disinterestedness should impute to a professional firm from an individual partner is problematic. State ethical codes, while they may present retention issues of their own as discussed below, should not be relied upon to interpret the meaning of a federal bankruptcy statute. Doing so confuses two distinct standards. In *In re Wells Benrus*, the provision relied upon provided that the conflict would impute if the attorney was disqualified "under a Disciplinary Rule."[66] Similarly, Model Rule 1.10 would disqualify a firm from representing a client if any lawyer in the firm would be prohibited from representing the client by Model Rules 1.7 or 1.9. The requirements of the ethics codes are quite different from the requirements of the Bankruptcy Code when it comes to conflicts that may prohibit retention of a Debtors' Counsel. Among other things, they contain nothing analogous to the "disinterestedness" standard which creates a per se bar on representation of a client regardless of whether such representation, or former representation, constitutes a conflict of interest. As a result, relying on state ethical codes to interpret § 101(14), which presents entirely distinct requirements from such ethical codes, is unjustified and illogical.

Perhaps unsurprising given the questionable reasoning of the foregoing cases, courts in other districts have disagreed with the per se imputation of individual conflicts to an individuals' firm. In *In re Creative Restaurant Management, Inc.*, the Bankruptcy Court for the Western District of Missouri found that a law firm did not fail the disinterested test merely because one of its members failed the test.[67] The court found that "the Bankruptcy Code contains no requirement that an entire law firm is per se ineligible for employment due to one of its members having previously served as an officer of the debtor" and rejected any reliance on the Model Rules, finding imputed disqualification under Model Rule 1.10 inapplicable to the situation at hand.[68] Similarly, in *In re Timber Creek, Inc.*, the court found that lack of disinterestedness of one partner should not be imputed on a per se basis to all the remaining partners in a law firm provided sufficient "screening mechanisms" or "curative measures" are implemented to prevent or insulate against the flow of, for example, confidential information, and the court criticized the decisions in cases like *Wells Benrus* and *Envirodyne* for their reliance on the Model Rules.[69] Indeed, in *In re Capen Wholesale,* the

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court found that a firm could not serve as the debtor's financial advisor and banker when a partner of the firm had, within the two years prior to the filing, been an officer of the debtor. The court did note that there was authority for the proposition that the entire firm may not be per se disqualified from representing a debtor solely because a partner of the firm was an officer, but that this could not be applied in the case at hand since the only person working with the debtor was the person who was not disinterested. *Id.* at 727 (citing *In re* S.S. Retail Stores Corp., 211 B.R. 699, 701 (B.A.P. 9th Cir. 1997)).

66. "If a lawyer is required to decline employment or to withdraw from employment under a Disciplinary Rule, no partner, or associate, or any other lawyer affiliated with him or his firm, may accept or continue such employment." MODEL CODE OF PROF'L RESPONSIBILITY DR 5-105(D) (1980).

67. 139 B.R. 902, 912–13 (Bankr. W.D. Mo. 1992).

68. *Id.*

69. 187 B.R. 240, 242–44 (Bankr. W.D. Tenn. 1995); *see also In re S.S. Retail Stores Corp.*, 211 B.R. at 703 (finding that while a partner of a law firm had been an officer

Northern District of Illinois found that, relying in part on *Creative Restaurant Management*, imputation of a lack of disinterestedness from an individual partner at a firm to the firm itself was not merited and that reference to the Model Rules of Professional Conduct did not require such a finding.[70]

Other courts, however, have managed to impute a lack of disinterestedness from a single partner to the entire firm without any reliance on state ethics codes. For example, in *In re Essential Therapeutics, Inc.*, the Bankruptcy Court for the District of Delaware addressed whether the fact that one partner at a firm had served as an officer of the debtors within two years prior to the bankruptcy filing would disqualify the firm from serving as Debtors' Counsel.[71] The firm argued that an ethical wall preventing any exchange of information between the partner and those involved in the representation would be sufficient to avoid disqualification, but the United States Trustee[72] claimed that the individual partner's service as an officer mandated disqualification of the entire firm and that an ethical wall was insufficient to cure such disqualification.[73] Noting the circuit split on the issue, the court concluded that a law firm is indeed disqualified as not being disinterested where one of its partners served as an officer of the debtor within two years prior to the filing, and it did so without any reliance on state ethics codes or reference to the ethical walls that had been established.[74] Rather, the court simply found that the partner's service as an officer prohibited the firm from representing the debtor on the grounds that not having this general rule would require the court to

> interrogate all the members (and even associates) of the firm who will be doing work on the file to ascertain whether the actions of the attorney who served as an officer of the debtor would impair their

within the preceding two years and therefore was not "disinterested" as required by § 327, such disinterestedness was not attributable to the entire firm and that "[t]he Code does not provide for disqualification of an entire law firm based on the non-disinterestedness of one of its attorneys"); Stanley v. Keravision, Inc. (*In re* Keravision, Inc.), 273 B.R. 614, 619 (N.D. Cal. 2002) (finding that a law firm was not disqualified from representing a debtor in possession "simply because one of its partners was an officer" of the debtor until three weeks before the debtor filed its bankruptcy petition); *In re* Cygnus Oil & Gas Corp., No. 07-32417, 2007 Bankr. LEXIS 1913, at *10 (Bankr. S.D. Tex. May 29, 2007) (siding with "the majority of circuits addressing this issue" to find that "no per se rule of disqualification exists under the Bankruptcy Code" and that "[h]ad Congress intended to impute a single member's disqualification to her entire firm, it would have done so").

70. 184 B.R. 547, 550–51 (N.D. Ill. 1995).

71. 295 B.R. 203 (Bankr. D. Del. 2003); *see also In re* Vebeliunas, 231 B.R. 181, 196 (Bankr. S.D.N.Y. 1999).

72. The United States Trustee's role is to monitor and oversee bankruptcy proceedings and ensure that debtors-in-possession, or court appointed trustees, abide by bankruptcy rules and procedures. For further description of the United States Trustee's role in bankruptcies, see *About the United States Trustee Program & Bankruptcy*, U.S. DEP'T OF JUSTICE: U.S. TRUSTEE PROGRAM, http://www.justice.gov/ust/eo/ust_org/about_ustp.htm (last updated Aug. 19, 2010).

73. *In re Essential Therapeutics*, 295 B.R. at 208.

74. *Id.* at 211.

> ability to act on behalf of the debtor and the estate in an impartial manner.[75]

It also found that Congress "apparently believed that service as an officer or director of a debtor within two years before the bankruptcy case was filed would affect 'the essential character of independence and disinterestedness which is required' of counsel for the estate," and "[g]iven the current climate of distrust of officers and directors of corporations" the partner at issue could be sued and it would be impossible for the firm to represent the debtors in such a suit.[76] The Third Circuit has also suggested that imputation may go the other way, and that an individual member of the firm may not be disinterested as a result of the lack of disinterestedness of the firm.[77]

C. Statutory Exceptions to the Requirements of § 327

The Bankruptcy Code contains two main exceptions to the rules set forth above in addition to the narrow exception found in § 1107(b).[78] First, § 327(c) provides that:

> a person is not disqualified for employment under [§ 327] 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.[79]

"Section 327(c) acknowledges the difficulties debtors have in large chapter 11 bankruptcies to retain competent attorneys with the resources to handle the scope of the cases."[80] While the exception "'prevents disqualification based *solely* on the professional's prior representation of or employment by a creditor' [it] does not obviate the essential requirement that a professional not have an interest adverse to the estate."[81] Courts have thus examined, upon a challenge by a creditor or the United States Trustee, whether a competing interest of the court-appointed professional created a meaningful incentive to act contrary to the interests of the estate.[82] Ultimately, under § 327(c), "[t]he question raised is whether the professional's judgment and advocacy would be clouded by divided loyalty to the

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75. *Id.* at 210–11.

76. *Id.* (quoting *In re* Phila. Athletic Club, Inc., 20 B.R. 328, 333 (E.D. Pa. 1982)).

77. *In re* Marvel Entm't Grp., Inc., 140 F.3d 463, 478 (3d Cir. 1998).

78. *See* Sonderby & McGuire, *supra* note 3, at 244 ("The exception under section 1107(b) is very narrow . . . and applies only to those professionals who are disqualified solely on the basis of their prior employment by the debtor-in-possession.").

79. 11 U.S.C. § 327(c) (2006). The requirements of § 327(c) are further discussed in Part I.D below.

80. *In re* Project Orange Assocs., LLC, 431 B.R. 363, 371 (Bankr. S.D.N.Y. 2010).

81. *Id.* (quoting Bank Brussels Lambert v. Coan (*In re* AroChem Corp.), 176 F.3d 610, 621 (2d Cir. 1999)).

82. *See, e.g.*, Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir. 1994); Shuck v. Seminole Oil & Gas Corp. (*In re* Seminole Oil & Gas Corp.), 963 F.2d 368 (4th Cir. 1992); *In re* Sullivan, No. 91-5501, 1992 WL 68613 (E.D. Pa. Mar. 31, 1992).

two clients."[83] In practice, much of the analysis may turn on whether the Debtors' Counsel represents, or previously represented, the creditor in connection with the debtor as opposed to a matter entirely unrelated to the bankruptcy proceedings.

Second, § 327(e) permits the retention of an attorney who has previously represented the debtor for a "specified special purpose, other than to represent the trustee in conducting the case" so long as the attorney "does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed."[84] As a result, an attorney who is not disinterested in all respects may be retained for a special purpose as long as the attorney is disinterested with respect to the matter for which the professional is retained.[85] Section 327(e) may not, however, be used to retain general bankruptcy counsel and a full analysis of § 327(e), the requirements thereunder, and the situations in which retention under § 327(e) is appropriate, is beyond the scope of this Article.[86]

D. Actual Conflicts, Potential Conflicts, and Appearances of Conflict

Corporate bankruptcies, particularly large corporate bankruptcies, may involve thousands of potential parties in interest, each of which is technically adverse to the debtor and may appear and litigate issues in the bankruptcy case. A question often arises regarding whether each of these entities should be treated as having an active conflict of interest for the purpose of evaluating retention of the Debtors' Counsel under § 327. Some courts have concluded that "the disinterestedness requirement includes the duty to avoid even the appearance of conflict of interest" and that as a result "professionals hired in bankruptcy cases should not have even a 'scintilla of personal interest' that might affect their ability to make impartial and independent decisions during the reorganization."[87] However, several courts have described a distinction between actual and potential conflicts.[88]

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83. Sonderby & McGuire, *supra* note 3, at 248.

84. 11 U.S.C. § 327(e).

85. *See, e.g.*, *In re Arochem*, 176 F.3d at 622; Stoumbos v. Kilimnik, 988 F.2d 949, 964 (9th Cir. 1993).

86. *See, e.g.*, Century Indem. Co. v. Congoleum Corp. (*In re* Congoleum Corp.), 426 F.3d 675, 687 (3d Cir. 2005); Michael R. Nestor & Ian S. Fredericks, *Getting Retained and Getting Paid in the 3rd Circuit: A Review of 2005 Bankruptcy Issues and Outcomes*, LEGAL INTELLIGENCER, Mar. 2006.

87. A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 MINN. L. REV. 875, 895 (2009) (quoting *In re* Vebeliunas, 231 B.R. 181, 192–93 (Bankr. S.D.N.Y. 1999)) (citing Smith v. Marshall (*In re* Hot Tin Roof, Inc.), 205 B.R. 1000, 1003 (B.A.P. 1st Cir. 1997); *In re* Kendavis Indus. Int'l, Inc., 91 B.R. 742, 753–54 (Bankr. N.D. Tex. 1988); *In re* Codesco, Inc., 18 B.R. 997, 999–1000 (Bankr. S.D.N.Y. 1982); *In re* Granite Partners, L.P., 219 B.R. 22, 33–34 (Bankr. S.D.N.Y. 1998); *In re* Roberts, 46 B.R. 815, 828 n.26 (Bankr. D. Utah 1985)). The appearance of impropriety conflict is embodied in Canon 9 of the Model Code of Professional Responsibility, which provides that an attorney "should avoid even the appearance of professional impropriety." MODEL CODE OF PROF'L RESPONSIBILITY Canon 9 (1980).

88. *See In re* Am. Printers & Lithographers, Inc., 148 B.R. 862, 866 (Bankr. N.D. Ill. 1992) ("Section 327(c) provides that an application to employ counsel should be

In *In re Marvel Entertainment Group, Inc.*, a seminal case acknowledging such a distinction, the Third Circuit Court of Appeals broke conflicts of interest into three categories and developed different rules for each. The court addressed denial of the trustee's request to engage a law firm as counsel to the trustee on the grounds that the firm's prior unrelated representation of a creditor in the bankruptcy prohibited the representation.[89] The firm was representing the creditor—a major party in interest in the bankruptcy actively involved in the negotiations and litigation surrounding the reorganization—in a construction financing of a performing arts center entirely unrelated to the debtors.[90] The firm's representation of the creditor in the matter had netted the firm $48,000 in fees the year before the bankruptcy began, which was about 0.1% of the firm's annual revenue.[91] Moreover, the creditor had granted the firm an unconditional waiver of any conflicts which might arise from the firm's service for the trustee.[92] Another creditor objected to the retention of the firm on the grounds that the firm was not disinterested as a result of its continuing representation of the creditor.[93] The district court held a hearing to consider the issue, and at the hearing the firm announced that its representation of the creditor had ended.[94] However, this did not pacify the objecting creditor, who claimed there was still a concern regarding the appearance of conflict.[95] The district court denied the retention of the firm on the grounds that the representation of the creditor "taints the image of objectivity that the trustee and his counsel should possess."[96]

On appeal, the Third Circuit overruled the lower court, finding that the court had misinterpreted the Third Circuit's precedent.[97] The court clarified that:

> (1) Section 327(a), as well as § 327(c), imposes a per se disqualification as trustee's counsel of any attorney who has an actual conflict of interest; (2) the district court may within its discretion—pursuant to § 327(a) and consistent with § 327(c)—disqualify an attorney who has a potential conflict of interest and (3) the district court may not disqualify an attorney on the appearance of conflict alone.[98]

As a result, the Third Circuit held that the lower court had erred in determining that the firm could be disqualified merely for an appearance of impropriety.[99] Moreover, the Third Circuit found that the firm in question did not have either a

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disallowed only when 'there is an actual conflict of interest.' Based on the use of the term 'actual', several courts have recognized a distinction between actual and potential conflicts." (citations omitted)); *In re Granite Partners*, 219 B.R. at 33.

89. 140 F.3d 463, 466–67 (3d Cir. 1998).
90. *Id.* at 469.
91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.*
96. *Id.*
97. *Id.* at 476.
98. *Id.*
99. *Id.* at 477.

potential or actual conflict because the firm "never represented [the creditor] on a matter related to th[e] bankruptcy and severed *all* attorney-client relations with [the creditor] in anticipation of its selection as trustee's counsel."[100]

The Third Circuit did not give much guidance in *Marvel* on what was "potential" and what was "actual" with respect to conflicts. Subsequent cases, however, have noted that "[d]istinguishing between potential and actual conflicts is a flexible enterprise, and necessarily it is one that is governed by the factual niceties of each particular case."[101] Typically, "a conflict is actual, and hence per se disqualifying, if it is likely that a professional will be placed in a position permitting [her] to favor an interest over an impermissibly conflicting interest."[102] "[A] potential conflict is said to occur where there is presently no competition between the [Debtor Counsel's] clients, but it might come into being if certain contingencies take place."[103]

Unfortunately for the professional trying to gauge what level of conflict she may have, these are matters committed to the bankruptcy court's discretion.[104] For example, in *In re Jade Management Services*, the court held that the bankruptcy court had appropriately found there was "at most" a potential conflict of interest as a result of a law firm's concurrent representation of the debtor in possession and the debtor's sole shareholder, who had guaranteed the debtor's secured debt.[105] Given the lack of clarity regarding what is "actual" versus "potential"—and the fact that the bankruptcy court has "discretion" to disqualify professionals with potential conflicts—the decision in *In re Marvel* has not clarified for Debtors' Counsel whether any given conflict could eventually prohibit their retention or payment.

Moreover, while many jurisdictions have followed the three part breakdown of *In re Marvel*, case law in several jurisdictions continues to question whether the distinction between actual and potential conflicts is meaningful at all.[106] For example, in *In re Granite Partners* the Bankruptcy Court for the Southern District of New York stated that counsel "represented adverse interests, and had a meaningful incentive, or the perception of one, to act contrary to the interests of the estate" and that disqualification is appropriate "if it is plausible that

100. *Id.*

101. *In re* Jade Mgmt. Servs., 386 F. App'x 145, 148 (3d Cir. 2010).

102. *In re* Pillowtex, 304 F.3d 246, 251 (3d Cir. 2002) (emphasis added).

103. Sonderby & McGuire, *supra* note 3, at 249.

104. *See In re Jade Mgmt. Servs.*, 386 F. App'x at 148 (citing *In re* BH & P, Inc., 949 F.2d 1300, 1316–17 (3d Cir. 1991)); *In re* Martin, 817 F.2d 175, 182–83 (1st Cir. 1987).

105. *In re Jade Mgmt. Servs.*, 386 F. App'x at 149.

106. *See* Kohn, Shuster & Powar, *supra* note 10, at 111 ("[A] split of authority exists regarding whether potential conflicts of interest should lead to automatic disqualification. One line of cases applies a rigid, strict constructionist rule, whereby the potential for conflict of the 'appearance of impropriety' constitutes a disqualifying conflict of interest."); Sonderby & McGuire, *supra* note 3, at 249.

the representation of another interest may cause the debtor's attorney to act any differently than they would without that other representation."[107]

E. The Impact of Conflict Waivers on the Bankruptcy Code Requirements

Given the strict requirements of the Bankruptcy Code relating to multiple representation, a common issue is whether waivers provided by clients can potentially provide relief from otherwise disqualifying conflicts. Most courts that have considered the issue, however, have refused to enforce client consents in bankruptcy cases, finding that the Bankruptcy Code's conflicts rules cannot be waived.[108] Courts have typically explained that conflict waivers simply do not trump the requirements of § 327(a).[109] For example, in *In re American Printers & Lithographers, Inc.*, the bankruptcy court found that a waiver of conflict did not permit retention of a proposed counsel for the debtor where the counsel also represented a secured creditor with which negotiations would be required, and noted that "[a] firm that is not disinterested may not represent a debtor even if that debtor has consented to such representation and waived the conflict."[110]

Thus "certain conflicts that a client could waive after full disclosure outside of the bankruptcy context, such as simultaneous representation of the client and client's creditor, are prohibited by the Bankruptcy Code itself from being waived."[111] Yet, injecting the usual uncertainty into the mix, a few courts have held that consent and conflicts waivers, although not controlling, are potentially indicative of the lack of disabling conflict.[112]

*F. Rule 2014—Everything (*Everything*) Must Be Disclosed By Affidavit*

In addition to § 327 of the Bankruptcy Code, Federal Rule of Bankruptcy Procedure 2014 addresses the retention of professional persons. Bankruptcy Rule 2014 requires an attorney seeking employment as Debtors' Counsel to provide an affidavit that states all of the professional's "connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United

107. *In re* Granite Partners, L.P., 219 B.R. 22, 36 (Bankr. S.D.N.Y. 1998); *id.* at 33 (quoting *In re* Leslie Fay Cos., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994)) (internal quotation marks omitted).

108. *See, e.g.*, *id.* at 34; *In re* Trust Am. Serv. Corp., 175 B.R. 413, 420 (Bankr. M.D. Fla. 1994); *In re* Am. Printers & Lithographers, Inc., 148 B.R. 862, 867 (Bankr. N.D. Ill. 1992); *In re* Amdura Corp., 121 B.R. 862, 866 (Bankr. D. Colo. 1990).

109. *See In re* Project Orange Assocs., LLC, 431 B.R. 363, 375 (Bankr. S.D.N.Y. 2010).

110. 148 B.R. at 867 ; *see also In re* RKC Dev. Corp., 205 B.R. 869, 872 (Bankr. S.D. Ohio 1997); Robin E. Phelan & John D. Penn, *Bankruptcy Ethics, An Oxymoron*, 5 AM. BANKR. INST. L. REV. 1, 27 (1997) ("What may be ethically acceptable in commercial settings (e.g., waivers upon informed consent) will not necessarily pass muster under section 327.").

111. *In re* Diamond Mortgage Corp., 135 B.R. 78, 90 (Bankr. N.D. Ill. 1990).

112. *See, e.g.*, *In re* Head, 110 B.R. 621, 625 (Bankr. M.D. Ga. 1990); *In re* Direct Satellite Commc'ns, Inc., 96 B.R. 507, 521 (Bankr. E.D. Pa. 1989); *In re* Lee, 94 B.R. 172, 178–79 (Bankr. C.D. Cal. 1989); *In re* Global Marine, Inc., 108 B.R. 998, 1005–06 (Bankr. S.D. Tex. 1987).

States trustee, or any person employed in the office of the United States trustee."[113] "Under Rule 2014, a professional must disclose all facts pertinent to the court's determination as to whether the professional is disinterested or holds an adverse interest to the estate" and "[a]pplicants may not pick and choose which connections are irrelevant or trivial."[114]

Courts have generally interpreted Rule 2014 strictly, finding that the professional has no discretion regarding how material the connections must be to require disclosure.[115] Indeed, courts have noted that defective disclosure "goes to the heart of the integrity of the bankruptcy system."[116] A failure to disclose a connection is sufficient to warrant disqualification of a professional from employment.[117] An intentional failure to disclose a connection may even warrant criminal penalties.[118]

Additionally, the duty under § 2014 is a continuing one, such that professionals must apprise the court of any new issues, connections, or other matters that bear on the issue of disinterestedness after the professional's retention.[119] The seriousness of the Debtors' Counsel's obligations under § 2014 is demonstrated by the holding in *In re SonicBlue*, discussed below.

G. Punishments for Failing to Satisfy the Code's Requirements—Denial or Disgorgement of Fees Under Section 328(c)

Debtors' Counsel, like other professionals retained by a debtor, may only be paid after the bankruptcy court permits the retention of the Debtors' Counsel and after the bankruptcy court permits such payment.[120] Procedurally, after being

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113. FED. R. BANKR. P. 2014(a).

114. Sonderby & McGuire, *supra* note 3, at 251–52; *see also In re* BH & P, Inc., 949 F.2d 1300, 1317–18 (3d Cir. 1991); *In re* Jore Corp., 298 B.R. 703, 732 (Bankr. D. Mont. 2003); *In re* Granite Partners, L.P., 219 B.R. 22, 35 (Bankr. S.D.N.Y. 1998).

115. *See, e.g.*, *In re* Leslie Fay Cos., 175 B.R. 525, 536 (Bankr. S.D.N.Y. 1994); *In re* Granite Sheet Metal Works, Inc., 159 B.R. 840, 845 (Bankr. S.D. Ill. 1993); Nestor, Harron, & Fredericks, *supra* note 47, at 46 ("The disclosure required under Rule 2014 extends beyond identifying disqualifying conflicts; a professional must disclose all connections, not merely those that rise to the level of conflicts.").

116. *In re* B.E.S. Concrete Prods., Inc., 93 B.R. 228, 236–38 (Bankr. E.D. Cal. 1988).

117. Kravit, Gass & Weber, S.C. v. Michel (*In re* Crivello), 134 F.3d 831, 839 (7th Cir. 1998); Rome v. Braunstein, 19 F.3d 54, 59–60 (1st Cir. 1994); *In re* Universal Bldg. Prods., No. 10-12453, 2010 WL 4642046, at *11 (Bankr. D. Del. Nov. 4, 2010); *In re* Filene's Basement, Inc., 239 B.R. 845, 849–50 (Bankr. D. Mass. 1999).

118. *See* MILTON C. REGAN, JR., EAT WHAT YOU KILL: THE FALL OF A WALL STREET LAWYER (2004) (chronicling the disclosure failures of John Gellene and Milbank, Tweed, Hadley & McCloy in the bankruptcy proceeding of Bucyrus-Erie Corporation, and the subsequent criminal prosecution of Gellene for such failures).

119. *See In re Granite Partners*, 219 B.R. at 35.

120. *In re* Garden Ridge Corp., 326 B.R. 278, 280–81 (Bankr. D. Del. 2005) (finding that prior approval of a professional's employment is a necessary prerequisite to compensation under the Bankruptcy Code and that there is no exception under Bankruptcy Code § 503(b)(1)(A) for a professional who provided necessary and beneficial services to the estate, but whose retention was not approved).

retained the Debtors' Counsel must file a fee application which the bankruptcy court must approve, and all parties in interest have the opportunity to object to the fee application.[121] "Code section 328(c) provides a penalty for professionals who fail to satisfy the dual requirements of section 327(a)."[122] Section 328(c) of the Bankruptcy Code provides that:

> Except as provided in sections 327(c), 327(e), or 1107(b) of [the Bankruptcy Code], the court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under section 327 or 1103 of [the Bankruptcy Code] if, at any time during such professional person's employment . . . 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.[123]

Section 328(c) may be utilized to deny compensation for services previously rendered, or to disgorge fees already paid.[124] The First Circuit has noted that "[a]bsent the spontaneous, timely and complete disclosure required by section 327(a) and Fed. R. Bankr. P. 2014(a), court-appointed counsel proceed at their own risk."[125] "No professional is entitled to be paid through a bankruptcy court where there exists an opportunity for divided loyalty. If such manifests itself, the professional will ultimately be a volunteer, for no money will be paid from the estate in such a situation."[126] As noted above, the requirements may be imputed from an individual attorney to the attorney's firm.[127] As a result, if a single attorney in the Debtors' Counsel's firm, even one who did no work in connection with the bankruptcy representation, could be subject to § 328(c), the section may potentially be applied to deny compensation for services previously rendered by other attorneys within the firm.

Section 328(c) may also be used to revoke an order of employment and deny compensation if a professional fails to disclose connections in accordance with Rule 2014, and, in fact, a disclosure violation may result in sanctions regardless of whether there was any resulting harm.[128] Failure to disclose a

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121. Dickerson, *supra* note 87, at 895.

122. Sonderby & McGuire, *supra* note 3, at 253.

123. 11 U.S.C. § 328(c) (2006). Additionally, a bankruptcy court may only permit the payment of "reasonable compensation for actual, necessary services rendered by . . . [an] attorney." 11 U.S.C. § 330(a)(1)(A) (2006). Moreover, § 329 provides that an attorney must

> file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation

and that the "court may cancel any such agreement, or order the return of any such payment, to the extent excessive." 11 U.S.C. § 329(a)–(b) (2006).

124. *See In re* Lewis, 113 F.3d 1040, 1045–46 (9th Cir. 1997).

125. Rome v. Braunstein, 19 F.3d 54, 59 (1st Cir. 1994) (emphasis omitted).

126. *In re* Bonneville Pac. Corp., 196 B.R. 868, 874 (Bankr. D. Utah 1996).

127. *See supra* Part I.C.3.

128. Sonderby & McGuire, *supra* note 3, at 253.

connection may even constitute independent grounds for denial of some or all compensation to a professional.[129] For example, in *In re Paine*, all compensation was denied to a Debtors' Counsel as a result of the failure to disclose representation of an unsecured creditor in the case.[130] Indeed, the failure to disclose conflicts of interest is a common ground for the disgorgement of fees.[131] Criminal penalties may even arise under § 152 of Title 18 for knowingly making false statements relating to conflicts.[132]

While § 328(c) provides that the bankruptcy court "may" deny compensation, it does not compel this result. As a result, bankruptcy courts have wide discretion regarding whether fees should be denied or disgorged.[133] Courts have noted that "a conflict does not necessarily taint every aspect of the representation" and that the "complete denial of fees in the absence of actual injury might be 'draconian and inherently unfair.'"[134] However, a professional may be required to demonstrate that the equities of the case warrant "a deviation from the flat denial of all fees."[135] Moreover, other courts have found that a bankruptcy court "does not have the authority to allow employment of a professional with a conflict of interest, and that such employment is void ab initio."[136]

H. The Bankruptcy Code's Retention Requirements In Action: **In re Project Orange Associates** ***and*** **In re SonicBlue**

The application of the requirements of the Bankruptcy Code, and the consequences of a Debtors' Counsel's failure to satisfy them, can be further illustrated by a discussion of two recent cases involving large corporate debtors and the large law firms that were retained as Debtors' Counsel: *In re Project Orange Associates, LLC*[137] and *In re SonicBlue Incorporated*.[138]

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129. *In re* Leslie Fay Cos., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994).

130. 14 B.R. 272, 274–75 (Bankr. W.D. Mich. 1981).

131. *See, e.g.*, *In re* Occidental Fin. Grp., Inc., 40 F.3d 1059, 1062 (9th Cir. 1994) (conflict of interest relating to attorney's representation of debtors' principals, which was not disclosed, led to disgorgement of all fees); *Rome*, 19 F.3d 54 (law firm was denied all compensation after the firm failed to make a full disclosure of pre-petition financial transactions between the firm and the debtor and failed to obtain court authorization to represent the purchaser of the debtor's assets); Gray v. English, 30 F.3d 1319, 1324 (10th Cir. 1994).

132. 18 U.S.C. § 152 (2006); *see also* United States v. Gellene, 182 F.3d 578, 584–90 (7th Cir. 1999).

133. *See In re* Prince, 40 F.3d 356, 359 (11th Cir. 1994); *In re* Granite Partners, L.P., 219 B.R. 22, 41 (Bankr. S.D.N.Y. 1998).

134. *In re Granite Partners*, 219 B.R. at 41 (quoting *In re* GHR Energy Corp., 60 B.R. 52, 68 (Bankr. S.D. Tex. 1985)).

135. *Id.* at 42 (collecting cases) (awarding 41% of the total fees sought in the case).

136. Sonderby & McGuire, *supra* note 3, at 255 (citing authorities); *see also* Michel v. Federated Dep't Stores, Inc. (*In re* Federated Dep't Stores, Inc.), 44 F.3d 1310, 1320 (6th Cir. 1995).

137. 431 B.R. 363 (Bankr. S.D.N.Y. 2010).

138. 2007 Bankr. LEXIS 1057 (Bankr. N.D. Cal. 2007).

1. In re Project Orange Associates, LLC

The primary issue in *Project Orange* was whether the "use of conflicts counsel to deal with the debtor's largest unsecured creditor and essential supplier is sufficient to permit court approval under § 327(a) of the Bankruptcy Code of a debtor's choice for general bankruptcy counsel that also represents that creditor in unrelated matters."[139] The United States Trustee filed an objection claiming that the firm's representation of that largest unsecured creditor, General Electric (GE), as well as the firm's inadequate disclosures relating to relationships with other creditors, prohibited the retention.[140]

The debtor, Project Orange Associates, LLC, owned and operated a steam and electricity cogeneration facility in Syracuse, New York, and had entered into an agreement with GE pursuant to which GE was to provide certain maintenance and repairs on the facility.[141] Prior to the bankruptcy filing, one of the debtor's turbines suffered a catastrophic failure and then proceeded to suffer subsequent failures following the initial repairs performed by GE.[142] GE's performance under the maintenance agreement ultimately led to a series of disagreements between the debtors and GE, resulting in an arbitration proceeding filed by GE against the debtors for certain fees and interest for services under the agreement as well as the ultimate termination of the agreement.[143]

The debtor sought to retain DLA Piper LLP as general bankruptcy counsel. DLA Piper filed an initial declaration as part of the application to retain the firm which disclosed that GE was a substantial client of DLA Piper, although the particular GE affiliate that was a creditor of the debtor and counterparty to the maintenance agreement was not, and had never been, a client of the firm.[144] However, a supplemental declaration later disclosed that the specific GE affiliate that was a creditor of the debtor was, in fact, a client of DLA Piper's foreign affiliate but clarified that the law firm, due to its internal structure, did not receive any benefit from such representation.[145] Both declarations also disclosed past and present representations of many other potential parties in interest, although only consolidated GE represented greater than 1% of the firm's annual revenues.[146] A second supplemental declaration was subsequently filed by the firm that stated that DLA Piper would not sue GE but that the firm intended for conflicts counsel to handle such matters.[147] Moreover, despite the intent not to file any action against GE, DLA Piper had obtained a conflict waiver from GE to "shield it from allegations of ethical wrongdoing."[148] The conflict waiver prohibited the firm from bringing litigation or threats of litigation against GE, but permitted the firm to

139. 431 B.R. at 365.
140. *Id.* at 365–66.
141. *Id.* at 366.
142. *Id.* at 367.
143. *Id.*
144. *Id.* at 368.
145. *Id.*
146. *Id.*
147. *Id.*
148. *Id.* at 369.

negotiate with GE on all matters, and to be adverse to GE regarding relief from the automatic stay, use of cash collateral, debtor-in-possession (DIP) financing, or plan confirmation, provided that "any such position taken by [the Debtor could] not be more inconsistent with any provision of any intercreditor agreement."[149]

The bankruptcy court found that the conflict waiver, among other things, undermined the firm's contention that the GE entity that was a creditor of the debtor was not a client of DLA Piper, since the conflict waiver itself was between the firm and that specific GE entity.[150] Moreover, the conflict waiver combined the GE entity with other GE entities, thereby undermining the differentiation between the entity and the larger parent company.[151] DLA Piper, however, claimed that, with respect to GE and the other creditors that were clients of the firm, there was only potential adversity and not actual adversity, and, as a result, the firm could still be retained.[152] The bankruptcy court rejected this argument, refusing to distinguish between actual and potential conflicts and instead focused on the facts at hand to "determine whether an attorney has an adverse interest without limiting labels."[153]

The bankruptcy court proceeded to find a disqualifying conflict of interest between the firm and GE, focusing on the fact that there was litigation pending between GE and the debtors.[154] The court found that the conflict waiver did not allow DLA Piper to avoid these contracts, particularly since it did not permit the firm to be adverse to GE on all issues and did not permit the firm to represent the debtor in a suit against GE.[155] Further, the court noted that even if the conflict waiver was broad enough to permit adversity on all issues, this would not necessarily mean that the firm could satisfy the requirements of § 327(a).[156] Finally, the court found that the debtor's use of conflicts counsel did not permit retention of the firm as counsel to the debtor because the use of conflicts counsel could not permit the retention of a firm with a conflict of interests with a creditor that is central to the debtor's reorganization.[157] As a result of this conflict with GE, the court denied DLA Piper's retention application.[158]

2. In re SonicBlue Inc.

In *In re SonicBlue*, the debtors retained Pillsbury Winthrop Shaw Pittman, LLP (PWSP) as general bankruptcy counsel shortly after filing their petitions for

149. *Id.* (first alteration in original) (citing conflict waiver).
150. *Id.* at 371.
151. *Id.*
152. *Id.* at 373.
153. *Id.*
154. *Id.*
155. *Id.* at 374.
156. *Id.* at 374–75.
157. *Id.* at 375–76. The court relied on the holdings in *In re Amdura Corp.*, 121 B.R. 862 (Bankr. D. Colo. 1990), *In re Git-N-Go, Inc.*, 321 B.R. 54, 58–62 (Bankr. N.D. Okla. 2004), and *In re Envirodyne Industries, Inc.*, 150 B.R. 1008 (Bankr. N.D. Ill. 1993), but noted that the court was "surprised at the dearth of precedent on this point." *In re Project Orange*, 431 B.R. at 376 n.5.
158. *In re Project Orange*, 431 B.R. at 379.

bankruptcy. PWSP had previously served as the debtors' longtime general corporate and litigation counsel.[159] Prior to the bankruptcy, the debtors had raised financing in a private placement issuance of $75 million in senior secured subordinated convertible debentures.[160] These bonds were largely acquired by three bondholders.[161] Although the bonds were secured, the security was subordinate to certain other indebtedness of the debtors.[162] PWSP represented the debtors in the issuance of these bonds and, "[i]n its capacity as counsel to [the debtors], on April 22, 2002, PWSP issued to the senior bondholders a written opinion as to the enforceability of the debentures."[163] This opinion provided, among other things, that the bonds were duly executed and delivered, were enforceable against the debtors, and would constitute valid and binding obligations of the debtors.[164] The opinion letter provided that it was subject to, and limited by, the effect of applicable bankruptcy laws.[165] Six months after the issuance of the bonds, the debtors began to have difficulty meeting certain maturing financial obligations, and retained PWSP to represent the debtors in connection with any restructuring of its debt, including a bankruptcy filing.[166] Approximately six months later, and just short of a year after the issuance of the bonds, the debtors filed their petitions for bankruptcy.[167]

In the application to retain PWSP and the accompanying affidavit, PWSP disclosed that it had been the debtors' general corporate and litigation counsel since 1989, and that during such time PWSP had represented the debtors in a variety of areas, "including corporate and securities matters, mergers and acquisitions, litigation, and intellectual property matters."[168] Moreover, the affidavit disclosed that PWSP had represented, and currently represented, various creditors or stockholders of the debtors in matters unrelated to the debtors' bankruptcy cases.[169] PWSP did not disclose that it issued the opinion letter in connection with the issuance of the bonds a year prior to the bankruptcy filings.[170] Over the course of the next three years, the firm filed seven supplemental affidavits disclosing additional conflicts and relationships as they arose throughout the case, but never specifically disclosed writing the opinion letter.[171]

Due to cash constraints, the debtors quickly sold substantially all of their assets through a sale under § 363 of the Bankruptcy Code.[172] PWSP continued to represent the debtors in the wind down of the debtors' estates, including pursuing

159. *In re* SonicBlue, Inc., 2007 Bankr. LEXIS 1057, at *4 (Bankr. N.D. Cal. 2007).
160. *Id.* at *5.
161. *Id.*
162. *Id.* at *5–6.
163. *Id.* at *6.
164. *Id.* at *7.
165. *Id.*
166. *Id.* at *7–8.
167. *Id.* at *8.
168. *Id.*
169. *Id.* at *9.
170. *Id.* at *9–10.
171. *Id.*
172. *Id.* at *11.

and objecting to claims.[173] In 2006, PWSP contacted the bondholders regarding potential disallowance of a part of the bondholders' claim.[174] The bondholders replied to this challenge, in part, by referencing the opinion letter that PWSP had written in connection with the issuance of the bonds and asserting that the bondholders had relied on this opinion as assuring that their claims were allowable in a bankruptcy case.[175] Moreover, the bondholders claimed that they would demand that PWSP defend and indemnify them for any further losses resulting from the challenge to their claim.[176] PWSP immediately contacted the counsel for the unsecured creditors committee, informed them of the situation, and "turned over to the committee the task of prosecution of the objection to the claims of the senior bondholders."[177] PWSP did not file a supplemental affidavit regarding these developments, although in its application for interim compensation PWSP disclosed that the matter had been turned over to the creditors committee for further prosecution.[178]

Six months after the senior bondholders asserted these claims, the United States Trustee filed a motion for disqualification of PWSP as Debtors' Counsel. The United States Trustee asserted that PWSP had failed to meet the disclosure requirements of Rule 2014 because it failed to disclose the connection with the bondholders upon the initial affidavit and subsequently failed to disclose this even after the bondholders asserted the potential claims against PWSP.[179] The United States Trustee sought to have the employment order approving the retention of PWSP vacated, and all paid fees disgorged.[180] The United States Trustee claimed that PWSP held an interest directly adverse to the estate based on the opinion letter issued to the bondholders, and that PSWP's loyalties to the estate and the creditor body may have been seriously compromised as a result of the opinion letter.[181]

A few days after the motion of the United States Trustee, PWSP filed a supplemental affidavit disclosing the details of PWSP's representation of the debtors in connection with the bond issuance and the opinion letter.[182] PWSP asserted that its failure to previously disclose the connection was inadvertent.[183]

The bankruptcy court granted the United States Trustee's motion and vacated the order that had, years earlier, approved the retention of PWSP as Debtors' Counsel.[184] The court found that after the bondholders asserted the potential claims against PWSP there was a clear disabling conflict of interest that

173. *Id.* at *19.
174. *Id.* at *20.
175. *Id.* at *20–21.
176. *Id.* at *21.
177. *Id.* at *22.
178. *Id.*
179. Motion by United States Trustee to Disqualify Pillbury Winthrop Shaw Pittman LLP, to Vacate Employment Order, and for Disgorgement of Attorneys' Fees, *In re SonicBlue*, No. 03-51775 (Bankr. N.D. Cal. Feb. 20, 2007).
180. *Id.* at 11.
181. *Id.* at 10–11.
182. 2007 Bankr. LEXIS 1057, at *28.
183. *Id.* at *29.
184. *Id.* at *41–42.

PWSP knew about but failed to disclose to the court.[185] While PWSP claimed the failure to file a disclosure of the conflict both at the time of retention and later in the case was inadvertent, the court held that "whether intentional or inadvertent, PWSP's failure to disclose this significant and disabling conflict in any reasonable fashion mandates immediate disqualification of PWSP from its representation in [the] case."[186]

II. DEBTORS' COUNSEL'S OBLIGATIONS UNDER STATE ETHICAL CODES

In addition to satisfying the requirements of the Bankruptcy Code provisions relating to the retention of professionals, the Debtors' Counsel is also still subject to the same body of ethical rules governing non-bankruptcy practitioners—namely the local state ethical codes that govern attorney conduct in every jurisdiction as well as court-specific ethical rules.[187] As noted by one bankruptcy judge:

> Under the Model Rules, attorneys owe fiduciary duties of loyalty and care to their clients. The duty of loyalty includes the duty to maintain client confidentiality and prevent any conflict of interest under Model Rules 1.6, 1.7, 1.8, 1.9, and 1.10. The duty of care to the client encompasses counsel's duty to abide by the client's decisions regarding the legal objectives of the representation, and duties to act competently and with reasonable diligence, to zealously represent the client, to keep the client reasonably informed as to the representation, and to exercise independent judgment and render candid advice. These duties are the same for bankruptcy practitioners and for nonbankruptcy practitioners.[188]

Numerous authors have documented the problematic interaction between the Bankruptcy Code and the state ethical codes, and the host of reasons why the rules set forth in the Model Rules and Model Code, which form the basis of most state ethical codes, simply do not work in multi-party complex litigation scenarios such as bankruptcy.[189] A complete analysis of all these issues is beyond the scope

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185. *Id.* at *32–33.

186. *Id.* at *33–34.

187. *See, e.g.*, Century Indem. Co. v. Congoleum Corp. (*In re* Congoleum Corp.), 426 F.3d 675, 687 (3d Cir. 2005); *In re* Vanderbilt Assocs., Ltd., 117 B.R. 678, 680 (D. Utah 1990); *In re* Universal Bldg. Prods., No. 10-12453, 2010 WL 4642046, at *8 (Bankr. D. Del. Nov. 4, 2010); *In* re Soulisak, 227 B.R. 77, 80 (Bankr. E.D. Va. 1998); Kohn, Shuster & Powar, *supra* note 10, at 95 ("Attorney disqualification in bankruptcy is governed by two separate sources of law. The first is the Bankruptcy Code itself; the second is the ethical rules that govern the conduct of attorneys appearing before the court.").

188. Sonderby & McGuire, *supra* note 3, at 239 (citations omitted).

189. *See, e.g.*, Nancy B. Rapoport, *Our House, Our Rules: The Need for a Uniform Code of Bankruptcy Ethics*, 6 AM. BANKR. INST. L. REV. 45 (1998) [hereinafter Rapoport, *Our House, Our Rules*]; Nancy B. Rapoport, *Turning and Turning in the Widening Gyre: The Problem of Potential Conflicts of Interest in Bankruptcy*, 26 CONN. L. REV. 913 (1994) [hereinafter Rapoport, *Turning and Turning*] (focusing on conflicts issues

of this Article. Rather, this Article focuses on a few of those issues which may pose significant barriers to the retention, or the continued retention, of Debtors' Counsel that may not be covered by the rules and requirements of the Bankruptcy Code itself.

A. State Rules Relating to Conflicts of Interest with Current Clients

The majority of states have adopted ethical codes based on the Model Rules. Subsection (a) of Model Rule 1.7 provides that "a lawyer shall not represent a client if the representation involves a concurrent conflict of interest" and that a "concurrent conflict of interest exists if: (1) the representation of one client will be directly adverse to another client; or (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer."[190] The comments to Rule 1.7 further provide that a "lawyer may not act as an advocate in one matter against a person the lawyer represents in some other matter, even when the matters are wholly unrelated."[191] Nonetheless, subsection (b) of Model Rule 1.7 provides that:

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stemming for the shifting nature of conflicts of interest in bankruptcy); Rapoport, *Square Peg, Round Hole*, *supra* note 5, at 985; Smith, *supra* note 9, at 356–57; John D. Ayer, *How to Think About Bankruptcy Ethics*, 60 AM. BANKR. L.J. 355 (1986); Jay Lawrence Westbrook, *Fees and Inherent Conflicts of Interest*, 1 AM. BANKR. INST. L. REV. 287 (1993); Christopher M. Ashby, Comment, *Bankruptcy Code Section 327(a) and Potential Conflicts in Interest - Always or Never Disqualifying?*, 29 HOUS. L. REV. 433 (1992); Joseph D. Vaccaro & Marc R. Milano, Note, *Bankruptcy Code Section 327(a), A Statute in Conflict: A Proposed Solution to Conflicts of Interest in Bankruptcy*, 5 AM. BANKR. INST. L. REV. 237, 254 (1997).

190. MODEL RULES OF PROF'L CONDUCT R. 1.7(a) (2002). The Model Code contains similar standards. For example, Disciplinary Rule 5-105 provides that:

> (A) A lawyer shall decline proffered employment if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment, or if it would be likely to involve him in representing differing interests, except to the extent permitted under DR 5-105(C).
>
> (B) A lawyer shall not continue multiple employment if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by his representation of another client, or if it would be likely to involve him in representing differing interests, except to the extent permitted under DR 5-105(C).
>
> (C) In the situations covered by DR 5-105(A) and (B), a lawyer may represent multiple clients if it is obvious that he can adequately represent the interest of each and if each consents to the representation after full disclosure of the possible effect of such representation on the exercise of his independent professional judgment on behalf of each.
>
> (D) If a lawyer is required to decline employment or to withdraw from employment under a Disciplinary Rule, no partner, or associate, or any other lawyer affiliated with him or his firm, may accept or continue such employment.

MODEL CODE OF PROF'L RESPONSIBILITY DR 5-105 (1980).

191. MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 6.

> Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if: (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client; (2) the representation is not prohibited by law; (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and (4) each affected client gives informed consent, confirmed in writing.[192]

Model Rule 1.7, like much of the Model Rules, is focused on a litigation-oriented environment in which there are two parties who are fundamentally opposed. Application of conflicts rules based on Model Rule 1.7 in the bankruptcy setting is problematic for a number of reasons. As Nancy Rapoport has explained in a series of articles, the conflicts rules set forth by the state ethical codes simply do not function in an environment, such as bankruptcy, in which parties' positions and alliances are not static, but are instead constantly changing.[193] Counsel to a party involved in a bankruptcy action cannot reasonably know, at the outset of the representation, which other parties, if any, may end up in adverse positions.[194] "Unlike other forums and battlefields, where the lines of conflict are clearly drawn, in bankruptcy court, interested parties face proceedings with multiple litigants where the parties' interests, positions and relationships may change several times from pre-filing to post-filing and even thereafter."[195]

Moreover, although given less attention by commentators generally, Model Rule 1.7's requirement of consent from current clients may present a serious problem for the Debtors' Counsel—particularly in the bankruptcy of a large corporation. As discussed in Part III below, a large corporate bankruptcy may involve thousands of potential parties in interest, hundreds of which may be clients of the Debtors' Counsel. Model Rule 1.7 potentially requires that each of these clients give informed, written consent to the concurrent representation regardless of whether the conflict is an "actual" or "potential" conflict that could lead a bankruptcy court to find an "adverse interest" under § 327. In other words, if Model Rule 1.7 were strictly applied to the bankruptcy scenario, then a Debtors' Counsel could be prohibited from undertaking or continuing representation of the debtor if any of the potentially hundreds of clients which the Debtors' Counsel represented in other matters chose not to consent to such representation.[196]

It is unclear whether Model Rule 1.7 is intended to apply to the bankruptcy case as a whole, or perhaps just to actual adversity within the

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192. *Id.* R. 1.7(b).

193. Rapoport, *Our House, Our Rules*, *supra* note 189, at 45–50.

194. *Id.*

195. *In re* Flanigan's Enters., Inc., 70 B.R. 248, 250 (Bankr. S.D. Fla. 1987).

196. Smith, *supra* note 9, at 357 ("There is a very real problem with the application of state ethical rules to bankruptcy cases. The bilateral litigation rule does not work with respect to the bankruptcy case as a whole. If it is applied to the bankruptcy case as a whole, the result is that, absent consent of the other client, a lawyer is disqualified from representing a trustee or debtor in possession if the nonconsenting client is a creditor, equity security holder, or other party in interest, such as a party to an executory contract.").

bankruptcy case. More, it is unclear what "level" of adversity would trigger issues under Model Rule 1.7.[197] The Model Rules do not provide sufficient clarity and courts have varied on how strictly Model Rule 1.7 should be applied.[198] As a result, Debtors' Counsel has relatively little guidance regarding the application of Model Rule 1.7 in bankruptcy proceedings, and particularly in large corporate bankruptcy proceedings where there may be dozens, or hundreds, of actual and potential conflicts of interest between Debtors' Counsel and other current clients of the firm.[199]

B. Ethical Issues Stemming from the Lack of Client Identity

A host of troubling issues and potential restrictions on continued representation under state ethical rules stem from the current lack of clarity regarding the fiduciary duties of a Debtors' Counsel and, indeed, who is the Debtors' Counsel's client. Unfortunately, the fundamental issues of "who is the client?" and "to whom does counsel owe fiduciary duties?" in the context of chapter 11 debtor representation remain an area of split case law, with some courts finding that the client is the estate and that duties are owed to the estate, and others rejecting that notion and finding that the client is only the debtor in possession and that Debtors' Counsel owes no fiduciary duty to the estate.

In a recent article, Susan M. Freeman argues that the line of cases finding a fiduciary duty to the estate are fundamentally flawed and their conclusion problematic.[200] Freeman tracks the history of the notion of fiduciary responsibility to the bankruptcy estate, explaining that it "crept in" through attorneys' fees cases stemming from the Supreme Court's decisions in *Brown v. Gerdes*[201] and *Woods v. City National Bank & Trust Co.*,[202] and continued to evolve in cases with related fact patterns. The result was cases in many circuits finding that the Debtors' Counsel was a fiduciary to the estate and owed duties directly to the entire estate.[203] Freeman disagrees with the notion that a Debtors' Counsel owes duties to

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197. Similarly, it is unclear whether a bankruptcy court could circumscribe the requirements of Model Rule 1.7 if their strict application would result in the disqualification of qualified counsel to the detriment of the other creditors in the bankruptcy proceeding.

198. *See* Kohn, Shuster & Powar, *supra* note 10, at 107–10.

199. Similar issues are presented by Model Rule 1.9 for conflicts with former clients. Model Rule 1.9 provides that "a lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which the person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing." MODEL RULES OF PROF'L CONDUCT R. 1.9(a) (2002).

200. Susan M. Freeman, *Are DIP and Committee Counsel Fiduciaries for Their Clients' Constituents or the Bankruptcy Estate? What Is a Fiduciary, Anyway?*, 17 AM. BANKR. INST. L. REV. 291, 292 (2009).

201. 321 U.S. 178 (1944).

202. 312 U.S. 262 (1941).

203. Freeman, *supra* note 200, at 291–96 (quoting *In re* Hirsch, No. 1-02-17966-dem., 2008 WL 5234057, at *8 (Bankr. E.D.N.Y. Dec. 11, 2008); *In re* Arlan's Dep't Stores Inc., 615 F.2d 925 (2d Cir. 1979); Everett v. Perez (*In re* Perez), 30 F.3d 1209 (9th Cir. 1994); *In re* Taxman Clothing Co., 49 F.3d 310, 314 (7th Cir. 1995); Fellheimer, Eichen & Braverman, PC v. Charter Tech., Inc., 57 F.3d 1215, 1220, 1228 (3d Cir. 1995); Casco N.

the estate, and points to the detailed and reasoned critique of this premise set forth by the District Court for the District of Utah in *Hansen, Jones & Leta, PC v. Segal*.[204]

The court in *Hansen, Jones & Leta* found that the client of a Debtors' Counsel is, in fact, only the debtor in possession rather than the estate as a whole, and that as a result the Debtors' Counsel owes fiduciary duties to the debtor in possession and the court, but not the estate in the larger sense.[205] Further, although the debtor in possession is a fiduciary to the estate at large, the court found that this did not impose derivative fiduciary duties on the counsel, and that ethical problems under state ethical codes would arise for the Debtors' Counsel if such fiduciary duties to the estate were imposed as a result of the inherent conflicts of interest that exist for the debtor in possession.[206] In fact, the court explained that the rules of professional conduct governing attorneys would actually prevent an attorney from representing the plethora of conflicting interests that the debtor in possession is required to represent under the Bankruptcy Code.[207] The court concluded that the better position was that the Debtors' Counsel does not represent the estate, although the court noted that breaches of the Debtors' Counsel's duty to the debtor in possession could occur in the same situations which may have otherwise been considered a breach of the duty to the estate and that such services may fail to benefit the estate and therefore not be entitled to compensation under the Bankruptcy Code.[208]

Although a few courts have followed the reasoning and holding in *Hansen, Jones & Leta*, other courts have expressly rejected it.[209] Moreover, several commentators have long taken the view that the Debtors' Counsel's client is indeed the estate, and that the Debtors' Counsel owes fiduciary duties to the estate. For example, Nancy Rapoport and C.R. Bowles, Jr. have taken the position that the "Estate counsel represents the Estate—not its principals, not any of its creditors,

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Bank v. DN Assocs., (*In re* DN Assocs.), 3 F.3d 512, 516 (1st Cir. 1993); Interwest Bus. Equip., Inc. v. U.S. Tr. (*In re* Interwest Bus. Equip., Inc.), 23 F.3d 311, 316–17 (10th Cir. 1994); Zeisler & Zeisler, PC v. Prudential Ins. Co. of Am. (*In re* JLM, Inc.), 210 B.R. 19, 25 (B.A.P. 2d Cir. 1997)).

204. 220 B.R. 434 (D. Utah 1998).

205. *Id.* at 454–55.

206. *Id.* at 457–60.

207. *Id.* at 461.

208. *Id.* at 461–67. Freeman notes that:

> [I]nstead of imposing an undefined fiduciary duty to the estate and its beneficiaries on DIP counsel, which has broad and undefined ramifications that bankruptcy courts probably do not intend, courts can reach the same results by finding a breach of counsel's fiduciary duty to the client DIP, violations of Bankruptcy Rule 9011, Bankruptcy Code section 327 or 329, or failure to provide services which benefit the estate under Code section 330, or breaches of professional ethics codes or rules.

Freeman, *supra* note 200, at 383.

209. *See In re* Count Liberty, L.L.C., 370 B.R. 259, 279–81 (Bankr. C.D. Cal. 2007); C.R. "Chip" Bowles & Nancy B. Rapoport, *Debtor Counsel's Fiduciary Duty: Is There a Duty to Rat in Chapter 11?*, AM. BANKR. INST. J., FEB. 2010, at 64.

but the Estate."[210] They believe, in sharp contrast to the position of Freeman and the court in *Hansen, Jones & Leta*, that the Debtors' Counsel "is supposed to owe its allegiance to the Bankruptcy Estate and not to the principals of the Estate."[211] Rapoport and Bowles have analyzed the host of ethical issues that such a conclusion presents and how courts have dealt with such issues, including: does the Debtors' Counsel have an independent duty to investigate the debtor in possession; what are the duties of the Debtors' Counsel relating to fees, retainers, and applications for employment; what are the duties of the Debtors' Counsel regarding motions filed by creditors and the potential for the Debtors' Counsel to disagree with the debtor in possession regarding the opposition of such motions; what is the duty of Debtors' Counsel to report wrongdoing by the debtor in possession; and what is the duty of the Debtors' Counsel to actively oversee or police the conduct of the debtor during the pendency of the chapter 11 case.

Rapoport and Bowles have also detailed how a determination that the estate is the true client of Debtors' Counsel resolves many of these issues related to client identity, even though the exact nature of the estate remains unclear.[212] For example, if the client of the Debtors' Counsel is the estate, then, the authors conclude, the attorney–client privilege runs to the entire estate and not the debtor in possession management, and the Debtors' Counsel may reveal communications to the trustee without violating privilege.[213] In a subsequent article, the authors revisited this topic, and discussed the obligation of the Debtors' Counsel to "rat" on the debtors' management.[214] The authors argued that "because DIP counsel really represents the estate *qua* estate and not just the DIP itself," the "DIP counsel has a clear duty to rat on those running the DIP" for serious misconduct committed by debtors' management, while noting that there is no clear test for what misconduct is serious enough to warrant such ratting.[215] Yet, Rapoport and Bowles also note that such a duty might not be clearly understood by those enforcing state ethical codes, and that Debtors' Counsel may very well be punished for violating state ethical rules as a result of complying with the Debtors' Counsel's ethical duties.[216]

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210. Nancy B. Rapoport, *Has the DIP's Attorney Become the Ultimate Creditors' Lawyer in Bankruptcy Reorganization Cases?*, 5 AM. BANKR. INST. L. REV. 47, 48 (1997) (emphasis omitted).

211. *Id.* at 59 (citing *In re* Harp, 166 B.R. 740 (Bankr. N.D. Ala. 1993); *In re* Manguff, 147 B.R. 875, 879 (Bankr. E.D. Va. 1992); *In re* Rusty Jones, Inc., 134 B.R. 321, 343 (Bankr. N.D. Ill. 1991); *In re* Storms, 101 B.R. 645, 648 (Bankr. S.D. Cal. 1989)).

212. *Id.* at 89; *see also* Stephen McJohn, *Claims & Opinions: Person or Property? On the Legal Nature of the Bankruptcy Estate*, 10 BANKR. DEV. J. 465 (1994).

213. Rapoport, *supra* note 210, at 95. The lack of clarity regarding what exactly is "the estate" creates confusion if rules such as Model Rule 1.13 are to be applied to the Debtors' Counsel. Application of Model Rule 1.13 requires a chain of authority and clarity regarding the nature of the client, without which the Debtors' Counsel cannot know how the rule will apply. *See* Nancy B. Rapoport, *The Need for Bankruptcy Ethics Rules: How Can "One Size Fits All" Fit Anybody?*, 10 PROF. LAW. 20 (1998).

214. Bowles & Rapoport, *supra* note 209.

215. *Id.* at 65.

216. *Id.* at 65 n.20.

Either resolution regarding the identity of the client and fiduciary duties owed by counsel may present significant ethical challenges for the Debtors' Counsel under the applicable state ethical codes. Freeman points out the importance of this very question, noting that in "one 2008 case, the bankruptcy court sanctioned DIP counsel by reducing fees 'in light of [DIP counsel's] failure to acknowledge the existence of a fiduciary duty to the debtor's estate' even as it found 'counsel's actions have not constituted a breach of that duty.'"[217]

However, the lack of any resolution presents even more difficult issues. Assume the Debtors' Counsel becomes aware of certain non-continuing fiduciary breaches by members of the management of the debtor in possession. If Debtors' Counsel determines that the client is the estate, then Debtors' Counsel may act with such allegiance in mind and perhaps even disclose information to the United States Trustee without risk of violating ethical rules akin to Model Rule 1.6(a).[218] Yet, if Debtors' Counsel turns out to be incorrect, and such actions are challenged before a bankruptcy court that decides that the debtor in possession is actually the client, then Debtors' Counsel has now violated that same Model Rule and may be subject to sanctions for breach of the ethical rules and/or fee disgorgement under the Bankruptcy Code. Of course, if the Debtors' Counsel determines that the debtor in possession, rather than the estate, is the client, and a court later disagrees and finds that the estate is the client, then there is the parallel line of case law permitting sanctions for breach of the ethical rules and/or fee disgorgement under the Bankruptcy Code. Similarly, investigating the conduct of the debtor in possession may be appropriate if the client is the estate, but inappropriate if the client is the debtor in possession.[219] It is also entirely unclear how a Debtors' Counsel, whose retention (and withdrawal) is authorized and approved by the Bankruptcy Court, should accomplish a "noisy withdrawal" if so required by the state ethical rules.[220]

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217. Freeman, *supra* note 200, at 291 (quoting *In re* Hirsch, No. 1-02-17966-dem., 2008 WL 5234057, at *8 (Bankr. E.D.N.Y. Dec. 11, 2008)); *see also In re* Bonneville Pac. Corp., 196 B.R. 868, 878 (Bankr. D. Utah 1996) (criticizing Debtors' Counsel for failing to investigate the management for potential fraud).

218. Model Rule 1.6(a) provides that "[a] lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representing or the disclosure is permitted by paragraph (b)." MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (2003).

219. *Id.* at R. 2.1, cmt. 5 ("In general, a lawyer is not expected to give advice until asked by the client. However, when a lawyer knows that a client proposes a course of action that is likely to result in substantial adverse legal consequences to a client, duty to a client under Rule 1.4 may require that the lawyer act as if the client's course of action is related to the representation. . . . A lawyer ordinarily has no duty to initiate investigation of a client's affairs or to give advice that the client has indicated is unwanted, but a lawyer may initiate advice to a client when doing so appears to be in the client's interest.").

220. *See* C.R. "Chip" Bowles Jr., *Noisy Withdrawals: Urban Bankruptcy Legend or Invaluable Ethical Tool?*, AM. BANKR. INST. J., Oct. 2001, at 26 (discussing the applicability of ABA Formal Opinion 92-366 to the representation of chapter 11 debtors and explaining that "[i]t is the difficulties in balancing an attorney's duties to keep certain information confidential under Rule 1.6, with a duty to disclose fraud on a tribunal under Rule 3.3, that places debtor's counsel in such a difficult position"); Sonderby & McGuire,

III. WHY CONTINUED LACK OF GUIDANCE ON THE PROPER APPLICATION AND INTERPRETATION OF THE RETENTION RULES ARE PARTICULARLY PROBLEMATIC FOR LARGE CORPORATE DEBTORS

As demonstrated, the rules and requirements of the Bankruptcy Code are not well defined and are subject to court decisions which provide little guidance on what is or is not appropriate. For example, "[b]ankruptcy courts have been extremely inconsistent in deciding what 'disinterestedness' means: some apply the Bankruptcy Code's own definition of 'disinterested'; some use their home state's rules on conflicts of interest; and some use the Model Code or the Model Rules."[221] Moreover, the interaction between the Bankruptcy Code and the state ethical codes is similarly problematic, as discussed in Part II, and there has been little guidance on how a prospective Debtors' Counsel is to reconcile the disconnect between the rules commonly contained in state ethical codes and the bankruptcy system. This is unfortunate because the proper application and a clear understanding of the conflicts rules contained in both the Bankruptcy Code and the state ethical codes are critical for a Debtors' Counsel's retention and payment.

The lack of clarity is particularly problematic in the context of representing a corporate debtor in a chapter 11 proceeding. The representation of a corporate debtor requires counsel to undertake a variety of tasks that may be outside what is often considered the normal spectrum of client–attorney relationships. Regardless of whether a bankruptcy is a "prepackaged" or "pre-negotiated" reorganization, a traditional reorganization, an intended sale of assets under § 363 of the Bankruptcy Code, or even a defensive filing, the role of Debtors' Counsel requires the performance of a large range of services. Naturally, larger corporate debtors tend to have even larger numbers of issues and legal areas which must be addressed by Debtors' Counsel. Bankruptcy-related tasks that Debtors' Counsel may undertake during a representation of a chapter 11 task may range from the negotiation of cash collateral usage with a secured lender, to litigation with trade creditors over preference actions, to negotiations with environmental agencies over the remediation of hazardous sites.[222] Moreover, a large corporate debtor may need legal assistance from lawyers with specialties in tax, antitrust, litigation, mergers and acquisitions, corporate governance, environmental, regulatory, or other legal areas, as well as guidance on the bankruptcy spin that may be put on each of the issues arising within these legal areas.[223]

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supra note 3, at 241 ("While counsel must always take directions from its client, if counsel for the estate develops material doubts about whether a proposed course of action in fact serves the estate's interests, it must seek to persuade the client to take a different course or, failing that, resign." (citing Everett v. Perez (*In re* Perez), 30 F.3d 1209, 1219 (9th Cir. 1994))).

221. Rapoport, *Our House, Our Rules*, *supra* note 189, at 68.

222. *Id.* at 48.

223. *See* REGAN, *supra* note 118, at 326–28.

As a result, many large corporate debtors opt to retain firms as Debtors' Counsel which are capable of providing all of the above services. In the General Motors bankruptcy, the debtors retained, with court approval, Weil, Gotshal & Manges, LLP, a large international firm, as bankruptcy counsel.[224] During the first four months of the bankruptcy proceeding, well over 200 attorneys from Weil Gotshal, with a wide range of practice areas, billed more than ten hours to various legal matters relating to the proceeding.[225] Of course, the General Motors bankruptcy was one of the largest in history. But the large number of attorneys involved, while perhaps slightly higher than normal, is not unusual in the representation of large corporate debtors. For example, in the recent bankruptcy proceeding of Citadel Broadcasting Corporation, a substantially smaller corporation than General Motors, approximately forty attorneys from the Debtors' Counsel, Kirkland & Ellis, LLP, billed time to the proceeding in the first three months of the case.[226] Retaining smaller firms as general bankruptcy counsel and then seeking to retain a host of separate legal counsel for each additional area would likely lead to increased expenses for the debtor, to the detriment of all parties in interest.

However, in large corporate bankruptcies there are also typically thousands of potential parties in interest. These potential parties in interest may include, among others, equity holders, employees (and former employees), customers and vendors, members of the bank group providing secured or unsecured credit facilities, government agencies, and other professionals. Each potential party in interest could have a claim, or other cause of action, against the debtor that may ultimately result in negotiation or litigation with the potential party in interest. The law firms capable of providing the range of attorneys required to handle the various needs of large corporate debtors are typically sizeable, and may already represent hundreds of such potential parties in interest in matters unrelated to the bankruptcy. For example, approximately 250 potential parties in interest in the General Motors bankruptcy were former clients or current clients of Weil Gotschal, as disclosed in the application to retain the firm, and approximately another 100 potential parties in interest were disclosed as potential clients of the firm.[227] Similarly, more than 150 potential parties in interest in the Citadel

224. Application to Employ Weil, Gotshal & Manges LLP as Debtors Counsel / Application of the Debtors Pursuant to 11 U.S.C. §§ 327(a) and 328(a) and Fed. R. Bankr. P. 2014(a) for Authority to Employ Weil, Gotshal & Manges LLP as Attorneys for the Debtors, Nunc Pro Tunc to the Commencement Date, *In re* Motors Liquidation Co., No. 09-50026 (Bankr. S.D.N.Y. June 12, 2009).

225. First Application for Interim Professional Compensation/First Application of Weil, Gotshal & Manges LLP, as Attorneys for the Debtors, for Interim Allowance of Compensation for Professional Services Rendered and Reimbursement of Actual and Necessary Expenses Incurred from June 1, 2009 through September 30, 2009, *In re* Motors Liquidation Co., No. 09-50026, 2011 WL 18945 (Bankr. S.D.N.Y. Jan. 13, 2010).

226. First Interim Application of Kirkland & Ellis LLP, as Attorneys for the Debtors and Debtors in Possession, for Compensation for Professional Services Rendered and for Reimbursement of Actual and Necessary Expenses Incurred During the First Interim Compensation Period From December 20, 2009 Through March 31, 2010, at Ex. D, *In re* Citadel Broad. Corp., No. 09-17442 (Bankr. S.D.N.Y. May 19, 2010).

227. Application to Employ Weil, Gotshal & Manges LLP, *supra* note 224.

Broadcasting Corporation were former or current clients of Kirkland & Ellis, as disclosed in their retention application.[228]

Thus, the need to retain larger firms as Debtors' Counsel runs into issues when one considers the thousands of potential parties in interest and implications of a strict application of the conflicts rules found in both the Bankruptcy Code and the state ethical codes. Strict application of state ethical rules or the requirements of the Bankruptcy Code could very well prohibit larger firms from being retained as Debtors' Counsel, or limit the continued representation of a debtor after being retained.[229] Collier on Bankruptcy has noted that:

> In large chapter 11 reorganization cases with widespread creditor interests, it has become increasingly difficult to obtain the services of competent attorneys who are not only equipped with offices sufficiently staffed to handle all the varied legal services but are also able to meet the strict requirements of either the adverse interest rule or "disinterestedness."[230]

Courts have also referenced the difficulty that large corporate debtors may have in retaining appropriate legal counsel as a result of the application of the conflict rules governing such retention.[231] Section 327(c) has even been viewed as an acknowledgment of this very problem.[232] However, § 327(c) does not necessarily give the comfort one might expect, as some courts persist in disqualifying counsel despite lack of an actual conflict.[233]

A failure of Debtors' Counsel to comply with either the Bankruptcy Rules or the state ethical rules could very well lead to disqualification of the Debtors' Counsel, a loss of fees earned, a disgorgement of fees already paid, and even sanctions from the state bar. Yet the lack of clarity regarding how these very rules should be interpreted and applied means that "a lawyer or law firm whose conflict antennae are not precisely calibrated with those of a judge, who might pass on the issue, may be forced to forfeit the entire fee that otherwise would be due for extensive work on the matter."[234]

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228. Debtors' Application for Entry of an Order Authorizing the Employment and Retention of Kirkland & Ellis LLP as Attorneys for the Debtors and Debtors in Possession Nunc Pro Tunc to the Petition Date, at Schedule 2, *In re* Citadel Broad. Corp., No. 09-17442 (Bankr. S.D.N.Y. Jan. 8, 2010).

229. Smith, *supra* note 9, at 358 ("As happened once before, law firms of any size will abandon the representation of trustees and debtors in possession. Only firms specializing in the representation of trustees will be able to represent trustees, and only firms specializing in the representation of debtors will be able to represent debtors in possession.").

230. 3 COLLIER, *supra* note 3, ¶ 327.04[7][b].

231. *See, e.g.*, *In re* Project Orange Assocs., LLC, 431 B.R. 363, 371 (Bankr. S.D.N.Y. 2010).

232. 3 COLLIER, *supra* note 3, ¶ 327.04[7][b].

233. *Id.* ¶ 327.04[7][c] (citing *In re* Amdura Corp., 121 B.R. 862, 868–69 (Bankr. D. Colo. 1990); *In re* Lee Way Holding Co.,100 B.R. 950, 958–59, 961 (Bankr. S.D. Ohio 1989)).

234. Wolfram, *supra* note 6, at 384.

The current trend appears to be that, in a few cases each year, bankruptcy judges will apply the conflicts rules strictly and prohibit retention or payment of counsel. Examples of this trend are seen in *Project Orange* and *SonicBlue*, discussed in Part I.H above. DLA Piper may have been hard pressed to determine ahead of time that a bankruptcy court would be unwilling to permit conflicts counsel to address the litigation pending between the debtor and GE, and may have thought that the firm's ability to be adverse to GE in negotiations would permit retention of the firm. There is certainly no clear case law that could have guided the firm to a different conclusion. Similarly, PWSP may not have considered the opinion letter to cause the level of adversity with the "estate" that would disqualify PWSP from the role of Debtors' Counsel, and, since the opinion letter was written in the context of PWSP's representation of the debtor, may have even believed that there was no conflict at all with the estate. Again, there appears to be no definitive guidance that would have compelled such a conclusion.

These cases also demonstrate that prospective Debtors' Counsel must make their decision regarding whether conflicts should prohibit representations even though "the judicial decision will come down many months or years after the lawyer will have been forced to decide whether to represent the bankruptcy client."[235] For example, in the *Project Orange* decision discussed in Part I.H.1 above, the bankruptcy petition was filed on April 29, 2010, and the determination that DLA Piper could not represent the debtor in possession was issued on June 23, 2010. During these two months, DLA Piper continued representing the debtor in all matters. The status of the firm's fees are uncertain, as no fee application has yet been filed. Meanwhile, in *SonicBlue*, PWSP had been representing the debtor for years before the issues relating to the opinion letter were raised, yet the bankruptcy court found, years after approving the retention, that the firm should never have been retained in the first place.

The lack of guidance on such issues means that Debtors' Counsel is faced with difficult decisions at the outset on whether to undertake representations, and the attorneys may not be able to determine, in any given case, whether they will ultimately be working for free. Certainly, complete and full disclosure at the outset can provide quicker answers to such issues (and is compelled by Rule 2014). But, as shown above, prompt disclosure alone does not resolve the lack of clarity and guidance regarding the proper application of the Bankruptcy Code and state ethical rules.

IV. PROPOSED SOLUTIONS TO PROVIDE CLARITY AND GUIDANCE

The confused state of the law, the lack of guidance to counsel, and the potential issues that face a counsel involved in a bankruptcy, have been detailed by several authors, as has the potential that such issues may limit a debtor's ability to retain adequate counsel.[236] Over the past several decades a number of solutions have been proposed.

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235. *Id.*; *see also* Nestor, Harron, & Fredericks, *supra* note 47, at 46 ("The irony of [Rule 2014] is that disclosure is required at the beginning of the case, but its impact may not be known until the end of the case.").

236. *See* Westbrook, *supra* note 189.

For example, during the late 1990s a group of academics and practitioners pushed for the American Law Institute to address the issues relating to representations in bankruptcy proceedings as part of the Restatement of the Law Governing Lawyers.[237] In fact, a subsection of Restatement § 209 was proposed at one point that would have specifically dealt with conflicts of interest in multi-party, multi-claim litigation situations such as bankruptcy.[238] The section, in one of its incarnations, would have provided that:

> Certain types of civil proceedings, such as bankruptcy cases, may involve multiple parties and multiple disputes. The fact that one client holds a monetary claim against another client in a bankruptcy proceeding is not necessarily "assertion" of a claim for purposes of this Section. A claim is "asserted" or "defended" when a dispute concerning the claim is involved. When there is no substantial likelihood that the proceeding will devolve from administration of the estate into contested proceedings between two or more clients, no conflict of interest under this Section is ordinarily presented as between the clients. Further, a discrete conflict between two clients, such as a dispute over the validity of a claim in a bankruptcy proceeding, may not disqualify a lawyer from representing one client with respect to aspects of the case not involving the dispute between its clients. In addition to general conflicts rules that may apply, a lawyer must also comply with statutory regulations if more stringent, such as provisions of the bankruptcy code.[239]

However, the proposal ultimately failed, partially because of opposition from certain members of the judiciary combined with drafting disputes.[240] The final draft of the Restatement makes no reference to the complicated and confused ethical issues relating to bankruptcy.[241]

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237. Wolfram, *supra* note 6, at 385.

238. *Id.* at 386–87.

239. *Id.* at 389. An amendment to the comments to Section 209 would have provided:

> *Complex and multi-party litigation*. Not all possibly differing interests of co-clients in complex and multi-party litigation involve material interests creating conflicts. Determination whether a conflict of material interests exists requires careful attention to the context and other circumstances of the representation and in general should be based on factors such as the following: (1) whether issues common to the clients' interests predominate, (2) circumstances such as the size of each client's interest, and (3) the extent of active judicial supervision of the representation. Among other considerations, assessment of the existence of a conflict should take into account the requirements of materiality (see § 210 & Comment c(ii) thereof) and substantial risk (see *id.* & Comment c(iii) thereto) of conflict. In addition to general conflict of interest rules that may apply, a lawyer representing such multiple clients must also comply with statutory regulations if more stringent.

Id.

240. *Id.* at 390–91.

241. *Id.* at 391; *see also* Smith, *supra* note 9, at 350–51.

While the Restatement was contemplating, and ultimately rejecting, whether to address the conflicts issues presented in bankruptcy, there was also a movement within the National Bankruptcy Review Commission in support of recommending that Congress eliminate the "disinterested" requirement of § 327.[242] The National Bankruptcy Review Commission took up the task after the House of Delegates of the American Bar Association recommended eliminating the disinterestedness requirement for Debtors' Counsel.[243] The primary motivation behind the elimination of the disinterested prong of § 327 was simplifying and clarifying the standards to be applied to the retention of professionals by focusing a "bankruptcy court's inquiry on the question whether there was a substantial risk that [an] asserted conflict would materially and adversely affect the lawyer's bankruptcy representation."[244]

A host of law review articles were written debating the topic.[245] Some authors argued that application of the disinterestedness requirements to the retention of Debtors' Counsel was a drafting error and never intended in the first place.[246] Ultimately, this proposal was not made by the National Bankruptcy Review Commission. Instead, in 1997, the National Bankruptcy Review Commission suggested to Congress that the disinterestedness requirement for counsel for the estate be slightly relaxed and that there be a provision for the nationwide admission of bankruptcy counsel.[247] Neither recommendation would have eased the barriers to retention of adequate Debtors' Counsel or the ethical tensions discussed herein, and ultimately neither was taken up by Congress.[248]

Charles Wolfram, who was chief reporter for the Restatement of the Law Governing Lawyers, has suggested that the failure of both the American Law Institute and the National Bankruptcy Review Commission to address the issues relating to bankruptcy conflicts may have resulted from the lack of clarity in the field as well as the fact that both movements were underway at the same time, presenting a level of volatility in the state of the law.[249] Professor Wolfram suggested that conceivably "appropriate and adequate reform" could be made through judicial decisions interpreting the Bankruptcy Code, or perhaps future

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242. Wolfram, *supra* note 6, at 392.

243. Smith, *supra* note 9, at 349.

244. Wolfram, *supra* note 6, at 392; *see also* Gonzalez, *supra* note 44; Smith, *supra* note 9, at 350–51.

245. *See, e.g.*, Wolfram, *supra* note 6, at 392–94; *see also* Gonzalez, *supra* note 44; Smith, *supra* note 9, at 350–51; Todd J. Zywicki, *Mend It, Don't End It: The Case for Retaining the Disinterestedness Requirement for Debtor in Possession's Professionals*, 18 MISS. C. L. REV. 291 (1998); Todd J. Zywicki, *Of Bubbling Pots and Bankruptcy Ethics: A Comment on Wolfram and Smith*, 18 MISS. C. L. REV. 399 (1998).

246. *See* Smith, *supra* note 9, at 331 (providing excellent detail on the history of the Bankruptcy Code and the motivations behind the retention requirements contained therein).

247. NAT'L BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS, FINAL REPORT (1997).

248. *See* Smith, *supra* note 9, at 349 (noting that the National Bankruptcy Review Commission "dropped the ball on any meaningful reform of the Bankruptcy Code with respect to employment of professionals").

249. Wolfram, *supra* note 6, at 395.

legislative reform.[250] Unfortunately, in the twelve years since Professor Wolfram wrote such words, neither has occurred.

Professor Rapoport has suggested that the establishment of a uniform code of bankruptcy ethics may actually be what is required to remediate the confusion surrounding the application of state ethical codes to bankruptcy practice.[251] Professor Rapoport notes several reasons why such a uniform code is necessary, including the poor fit between the state ethical codes and bankruptcy practice, as well the need to make "difficult decisions" on key bankruptcy concepts such as the identity of the client and disinterestedness.[252] Indeed, Professor Rapoport notes that "[e]ven the few inroads regarding specialized bankruptcy ethics, such as the 'disinterested' requirement for professionals hired to represent the bankruptcy estate—as set forth in sections 327(a) and 101(14)—have been inconsistently applied, thanks to the overlay of state ethics codes" and that the result of the inconsistent application of the bankruptcy retention rules means that "debtors-in-possession can't know, when they seek approval of counsel to represent them, whether they'll get counsel familiar with their case or brand-new counsel who must be brought up to speed."[253] Professor Rapoport explains further that "bankruptcy lawyers—*especially* those involved in the commercial bankruptcy area—have a pretty hefty need for some relief" and that "the Bankruptcy Code would work more smoothly if bankruptcy lawyers understood their ethical duties."[254]

An alternative solution may be amending the Model Rules of Professional Conduct to address complicated litigation scenarios such as bankruptcy. As Professor Schneyer has previously suggested, the development of practice-area-specific rules may ultimately be the result of a legal world that is increasingly becoming more specialized—particularly in areas that are primarily governed by federal law.[255] Bankruptcy, and particularly the representation of a debtor in possession, may constitute fertile ground for the ABA to consider venturing into

250. Wolfram, *supra* note 6, at 397–98.

251. Rapoport, *Square Peg, Round Hole*, *supra* note 5, at 983; Rapoport, *supra* note 213; Rapoport, *Our House, Our Rules*, *supra* note 189, at 48; Rapoport, *Turning and Turning*, *supra* note 189.

252. Rapoport, *Our House, Our Rules*, *supra* note 189, at 47–48.

253. *Id.* at 67–69.

254. *Id.* at 81–83.

255. *See* Ted Schneyer, *The Regulatory Implications of Trends in Law Practice: Thoughts on Data Reported in Urban Lawyers*, 2006 PROF. LAW. 47 (analyzing data set forth in JOHN P. HEINZ, ROBERT L. NELSON, REBECCA L. SANDEFUR & EDWARD O. LAUMANN, URBAN LAWYERS: THE NEW SOCIAL STRUCTURE OF THE BAR 3–29 (2005)). Throughout his career, Ted Schneyer has published groundbreaking articles on numerous issues raised by particular lawyer–client relationships and by application of ethical rules and standards in practice, including *The Organized Bar and the Collaborative Law Movement: A Study in Professional Change*, 50 ARIZ. L. REV. 289 (2008), *An Interpretation of Recent Developments in the Regulation of Law Practice*, 30 OKLA. CITY U. L. REV. 559 (2005), *Regulatory Controls on Large Law Firms: A Comparative Perspective*, 44 ARIZ. L. REV. 593 (2002) (co-author, with Geoffrey C. Hazard, Jr.), and *Reforming Law Practice in the Pursuit of Justice: The Perils of Privileging "Public" over Professional Values*, 70 FORDHAM L. REV. 1831 (2002).

the development of such “area-specific” rules, as bankruptcy courts have noted the particular force with which the ABA Model Rules of Professional Conduct and similar professional codes may apply in bankruptcy proceedings, despite the renowned poor fit between the two.[256]

CONCLUSION

Despite the lack of clarity with respect to the rules governing retention, and continued retention, of Debtors’ Counsel and the applicability of state ethical codes to the Debtors’ Counsel, neither Congress, the ALI, nor the ABA have shown any intent to remediate the situation. Indeed, the largest movement for such change occurred over a decade ago, and little change resulted. Instead, prospective Debtors’ Counsel are confronted with a lack of clarity or guidance with respect to whether any given engagement should be undertaken, or if the firm will be exposed to fines, fee reductions, or fee disgorgements at some later date as a result of a judicial interpretation that did not perfectly align with the difficult decisions made by Debtors’ Counsel when contemplating the representation.

This Article has shown that these issues are particularly problematic in the context of large corporate bankruptcies. As discussed, large corporate debtors typically need to retain large law firms in connection with their restructurings as a result of the sheer number and diversity of issues that arise. At the same time, these companies may have hundreds or thousands of creditors. Finding a large law firm that is not currently representing any of those creditors is often difficult if not impossible. The relief provided by the Bankruptcy Code—that simultaneous representation of a creditor is not, by itself, sufficient to disqualify a professional—provides little comfort given the ongoing lack of clarity about what level of adversity constitutes an adverse interest, how strictly disinterestedness should be applied, whether disinterestedness will be imputed, the impact of conflicts waivers, and the other issues discussed herein. Moreover, it is unclear whether lack of consent from a potential party in interest who is also represented by the Debtors’ Counsel should prohibit the Debtors’ Counsel’s representation under state ethical rules despite the language of § 327(c) that could permit such representation. It is also unclear what level of adversity in a bankruptcy matter is significant for the purposes of state ethical codes. The lack of guidance regarding client identity injects additional uncertainty into an already confused area, presenting Debtors’ Counsel with decisions on issues that will impact future retention without any guidance on how such issues are to be addressed.

Certainly, where inappropriate conduct occurs, Debtors’ Counsel deserves to be penalized or sanctioned if the conduct so merits. However, the exact nature of what will constitute inappropriate conduct should not be left undefined. If courts uniformly applied all rules and requirements of the Bankruptcy Code and the state ethical codes strictly, then it would perhaps preclude large corporate debtors from retaining adequate counsel at all.

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256. *See, e.g.*, Century Indem. Co. v. Congoleum Corp. (*In re* Congoleum Corp.), 426 F.3d 675, 687 (3d Cir. 2005) (“Rules governing professional conduct are often viewed as even more necessary and applicable in bankruptcy cases than in other contexts.”).

The appropriate solution to this problem is legitimate reform, rather than a continuing inconsistent application of the rules and regulations that results in periodic punishments for firms who choose to undertake the representation of a chapter 11 debtor. The proposals discussed herein for arriving at such legitimate reform all have merit, but have been largely ignored by the ABA, the ALI, and Congress—the bodies most capable of actually providing the necessary guidance. Continuing to ignore this troubled area may threaten the ability of a debtor, particularly a corporate debtor, to retain adequate legal counsel.