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Interested But Disinterested: Conflicts In Bankruptcy

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Attorneys have a duty of loyalty to their clients to advocate for their interests. The word attorney was first used in the 15th century and is derived from the word attorn, meaning stepping into the position of another.[1]

It is well understood that attorneys must avoid conflicts of interests and that an attorney and her firm should not represent two clients who are adverse to each other. However, conflicts rules go further: attorneys themselves should not hold interests which could be adverse to their client.

Conflicts are addressed generally by the Model Rules of Professional Responsibility. Specifically, Rule 1.7 states:

a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. 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.

In addition, in connection with bankruptcy matters, the United States Bankruptcy Code (the "**Code**") contains rules governing disinterestedness. Section 327 of the Code provides for the employment of professional persons in a bankruptcy case, including attorneys, and prohibits a professional from being employed if they are not disinterested.

As defined in the Code, a person is disinterested who: "(a) is not a creditor, an equity security holder, or an insider; (b) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; **and** (c) does not have an interest materially adverse to the interest of the estate or 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 reason." 11 U.S.C. § 101(14).

However, "adverse interest" is not defined in the Code. Courts have stated that adverse interests "exists when two or more entities possess or assert mutually exclusive claims to the same economic interest." *In re Granite Sheet Metal Works*, 159 B.R. 840, 845 (Bankr. S. Ill. 1993). In the Second Circuit, to determine whether an adverse

interest exists, courts use an objective test involving a fact-specific inquiry. *In re Doug Gross Constr., Inc.*, 2024 Bankr. LEXIS 1406, *4 (Bankr. W.D.N.Y. 2024). This objective test "precludes 'any interest or relationship, however slight, that would even faintly color the independence and impartial attitudes required by the Code and Bankruptcy Rules.'" *Id*. (internal citations omitted).

Law firms seeking to represent debtors and creditors' committees under Chapter 11 are required to submit a statement of disinterestedness. In a large law firm, preparation of such a statement requires extensive due diligence to uncover any possible conflicts, including direct conflicts with the proposed client or holding an interest which would destroy their disinterested status. This might include holding a claim for unpaid legal fees when representing the pre-bankruptcy debtor or having an attorney-client relationship with one of the debtor's secured creditors, even unrelated to the particular case.

Therefore, professionals seeking to be employed by the bankruptcy estate must make full and candid disclosures of all connections, both when applying for approval of their employment and on an on-going basis during the pendency of the case. As with conflicts, disinterestedness issues may be subtle with varying interpretations. Challenges to the disinterestedness status of a professional in a bankruptcy case often comes from the Office of the United States Trustee ("**UST**"), which is part of the U.S. Department of Justice. There have been a number of recent cases which illustrate the application of these concepts.

Most recently, in *In re Enviva Inc.*, 24-10453 (Bankr. E.D. Va. July 2, 2024), the Bankruptcy Court for the Eastern District of Virginia denied a motion for reconsideration and refused for a second time to allow a large firm to be a debtor's general counsel. Proposed general counsel presented, *inter alia*, what the UST called a "partial ethical wall" where the proposed general counsel would be able to concurrently represent the debtor along with a company that controlled 43% of the debtor's common stock and two of the thirteen seats on the debtor's board. The "partial ethical wall" established boundaries and limitations for attorneys that worked on matters relating to the debtor and for those who worked on matters for the shareholder company. Attorneys were placed on separate teams based on who they have billed time to since the petition date. For attorneys that have billed time on both the debtor and shareholder company, they were separated based on the amount of time they have billed to each matter.

The Court found this to be insufficient. First, the Court stated that the shareholder company accounted for 0.97% of proposed counsel's revenue for the first five months of 2024, which trends towards billings exceeding $9,000,000.00 for 2024. Second, the Court stated that there were 13 attorneys who were identified as having billed time to both the debtor and the shareholder company post-petition. The Court explained that proposed general counsel's use of post-petition time-keeping does not reflect the pre-petition ties with the shareholder company. The Court further explained that the use of post-petition timekeeping "does not inform the Court as to how extensive the overlap might have been during the run-up to the bankruptcy filing. . . ." *In re Enviva Inc.*, 24-10453 (Bankr. E.D. Va. July 2, 2024).

In the Second Circuit, the U.S. Bankruptcy Court for the Western District of New York overruled the UST's objection to debtor's application to employ counsel in a case. *In re Doug Gross Constr., Inc.*, 2024 Bankr. LEXIS 1406 (Bankr. W.D.N.Y. 2024). In this case, proposed counsel had recently merged with another firm. An attorney from the prior

firm represented the debtor's principal in tax matters prior to the merger. When proposed counsel submitted its application to represent the debtor in the bankruptcy case, the UST objected saying that the firm was not disinterested because proposed counsel currently represented the debtor's principal who was also a creditor of the debtor. The Court rejected the UST's argument.

The Court stated that proposed counsel was not currently representing the debtor's principal or ever did because the representation in question concluded prior to the merger. The Court explained that to determine whether proposed counsel was disinterested, courts only examine the present interests to see whether a party has an adverse interest. *Id*. at *4. Further, the Court explained that to be a disinterested person under the Code, "the proposed professional personally must have a 'prohibited interest.'" *Id*. at *6. The Court concluded stating that "[w]hile it is not contested that [the debtor's principal] is a creditor of the Debtor and that [the prior firm] represented [the debtor's principal] personally for a prior tax matter, that engagement concluded before the two law firms merged and before [proposed counsel] undertook its representation of the Debtor. No actual conflict of interest exists as a result of [proposed counsel's] representation of the Debtor." *Id*.

In *In re Ryan 1000, LLC*, 631 B.R. 722 (Bankr. E. Wis. 2021), the Court denied the application by debtor company to employ counsel for its chapter 11 case because proposed counsel was already representing 50% owners of the debtor company personally in their chapter 13 cases. The individual chapter 13 debtors, as owners of the chapter 11 debtor company, relied on income from the debtor company to fund their chapter 13 plan, among other things. The debtor company was therefore a creditor of the debtors. The Court found that representing the debtors personally in the chapter 13 case would be an adverse interest to the chapter 11 debtors' estate. Proposed counsel failed to disclose this concurrent representation.

The Court explained that "[t]he burden of disclosure is placed on the applicant to produce the relevant facts, rather than relying on the bankruptcy judge or parties in interest to conduct an independent factual investigation to determine whether the applicant has a conflict." *Id*. at 734. The Court reasoned that it did not believe that proposed counsel 'deliberately tried to evade the disclosure requirements. . .but his conduct demonstrates a lack of understanding of the applicable sections of the Code and Bankruptcy Rules, his obligations in this case, and the separate interests of the [individual debtors] and the debtor [company]." *Id*. at 737.

As these cases illustrate, Courts will look to the specific facts of each case to determine whether conflicts exists and whether an attorney is a disinterested party. It is encouraged that prior to submitting applications to the court for retention, attorneys should be mindful of their personal interests and also perform diligent inquiries as to whether there are any other potential conflicts that may destroy their disinterested status.

While the technical aspects may be parsed and argued, one never forgets that, as an attorney, we are advocates with a heavy fiduciary burden to act solely on behalf of our client.

Please note this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and the recipient. If you have any questions regarding the provisions discussed above, or any other aspect of bankruptcy law, please contact Michael H. Traison (mtraison@cullenllp.com) at 312.860.4230 or Kelly McNamee (kmcnamee@cullenllp.com) at 516.296.9166.

Footnotes

[1] https://www.merriam-webster.com/dictionary/attorn.

Practices

- Bankruptcy and Creditors' Rights

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