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BANKRUPTCY CODE SECTION 327(a) — NEW INTERPRETATION FORCES ATTORNEYS TO WAIVE FEES OR WAVE GOOD-BYE TO CLIENTS

“Until very recently bankruptcy, like sex, was looked upon as a necessary part of life, but not anything that respectable citizenry would publicly acknowledge.”¹

Recent years have seen an increase in the number of bankruptcy petitions filed.² More attorneys are finding themselves in the bankruptcy courts, even though they are not “bankruptcy experts.” Often, clients will seek the attorneys with whom they are most familiar to represent them in bankruptcy proceedings. A debtor may choose an attorney to represent him in bankruptcy proceedings because the attorney has previously represented the debtor, because the attorney is a shareholder or officer in the debtor corporation, or because the attorney has in some other way been affiliated with the debtor in the past. But a trap awaits the unwary attorney. Under Section 327(a) of the Bankruptcy Code³ (hereinafter referred to as the Code), the same factors of familiarity that caused the debtor to seek the services of a particular attorney could create a conflict of interest sufficient to prevent recovery of attorneys fees for services rendered in connection with the bankruptcy case.

This Comment will examine Section 327 of the Code, the bankruptcy provision regarding conflict of interest and will investigate the developing case law in this area.

Section 327(a) provides:

Except as otherwise provided in this section, the trustee, with the court’s approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, *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 trustee’s duties under this title.⁴

Section 327 is made applicable to debtors in possession by Section 1107 of the Code,⁵ which provides that a debtor in possession stands in the shoes of

1. Lavien, *Fees as Seen From the Bench*, 89 COMM. L.J. 136 (1984).

2. In 1975, a total of 254,484 bankruptcy petitions were filed in the United States. In 1985, 364,536 petitions were filed. The number of “business-related” petitions more than doubled from 1975 when about 30,000 such petitions were filed, to 1985 when nearly 67,000 petitions of this type were filed. STATISTICAL ABSTRACTS OF THE UNITED STATES, table 867 (107th ed. 1987).

3. 11 U.S.C. § 327 (1979).

4. *Id.* (emphasis added).

5. 11 U.S.C. § 1107 (1979). This section, entitled “Rights, powers, and duties of

a trustee in every way.⁶ Consequently, an attorney for a debtor in possession must meet the requirements set forth in Section 327(a) of the Code.⁷

The penalty for violating Section 327 is harsh. Section 328(c)⁸ authorizes a court to deny compensation for services and reimbursement of expenses where a professional represents an adverse interest.⁹

The principal that an attorney should not represent adverse interests is hardly novel. By the seventeenth century, common law had established that an attorney must not represent opposing interests.¹⁰ The usual consequence of disregarding this principle is the denial of attorneys fees.¹¹

The statutory requirement of employing only disinterested persons under Section 327 is rooted in the policy that professionals engaged to work on a bankruptcy case should be free of the slightest personal interest which might influence their decisions regarding the debtor's estate.¹² An attorney should not place himself in a position where he may be forced to choose between his own interest and the interest of his client.¹³ When an attorney is owed prepetition fees by the debtor in possession, the attorney acquires the dual status of attorney and unsecured creditor. The best interests of the debtor in possession may or may not be identical to those of the unsecured creditors. The

debtor in possession," provides as follows:

(a) Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under Section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in Sections 1106(a)(2)(3), and (4) of this title, of a trustee serving in a case under this chapter.

(b) Notwithstanding Section 327(a) of this title, a person is not disqualified for employment under Section 327 of this title by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case.

6. There are certain exceptions which are not relevant here. For example, a debtor in possession, unlike the trustee, does not have a right to compensation for managing the bankruptcy estate, nor does the debtor in possession have the investigative duties of the trustee. 11 U.S.C. § 1106(a)(2)-(4) (1979).

7. *In re Seatrain Lines Inc.*, 13 Bankr. 980, 981 (Bankr. S.D.N.Y. 1981).

8. 11 U.S.C. § 328(c) (1979) provides as follows:

Except as provided in Section 327(c), 327(e), or 1107(b) of this title, the court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under Section 327 or 1103 of this title. 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.

9. The requirements of § 327 and the penalties imposed by § 328 apply to all professionals hired by the trustee or the debtor in possession; however, this Comment will focus upon the employment of an attorney by the debtor in possession.

10. *Shire v. King, Yelverton* 32, 80 Eng. Rep. 24 (K.B. 1603); *Anonymous*, 7 *Modern* 47, 87 Eng. Rep. 1085 (Q.B. 1702).

11. *Silbiger v. Prudence Bond Corp.*, 180 F.2d 917, 920 (2d Cir. 1980).

12. 1 COLLIER, COLLIER BANKRUPTCY MANUAL ¶ 101.13 (1981).

13. *In re Roberts*, 46 Bankr. 815 (Bankr. D. Utah 1985).

Code's requirement that attorneys be disinterested and free from any potential conflicts of interest is easy to understand. The difficulty lies in recognizing and defining conflicts of interest in the bankruptcy context.

Under Section 327(a), a two-prong test must be met before an attorney or any other professional may be employed to assist with the bankruptcy estate.¹⁴ First, the attorney must hold no interest adverse to the estate.¹⁵ Second, the attorney for the trustee must be a "disinterested person."¹⁶ Section 101(13) of the Code defines a "disinterested person" as a person who:

- (A) is not a creditor, an equity security holder, or an insider;
- (B) is not and was not an investment banker for any outstanding security of the debtor;
- (C) has not been, within three years before the date of filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor;
- (D) is not and was not, within two years before the date of the filing of the petition a director, officer or employee of the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph; and
- (E) does not have an interest materially adverse to the interest of the estate or of any class of creditors.¹⁷

The definition of "disinterested person" was adopted with some modification from Section 158 of Chapter 10 of the Bankruptcy Act of 1898.¹⁸ Cases decided under Section 158 held that the tests of disinterestedness were to be rigidly applied and could not be waived because of the integrity or ability of the particular person involved.¹⁹ This notion still holds true today.²⁰

A "materially adverse interest" as prohibited by Section 101(13)(E)²¹ is not defined within the Code. This lack of definition promotes confusion in that 327(a) requires the professional must be disinterested as well as not hold an interest adverse to the estate, while the Code's definition of "disinterested person" expressly includes one that holds an interest materially adverse to the estate.

Determining precisely what type of relationship between an attorney and a debtor in possession will constitute a conflict of interest under Section 327 is further complicated. There is authority which suggests that the enunciated elements of Section 101(13) do not comprise an exclusive list of the criteria for

14. *In re Leisure Dynamics*, 33 Bankr. 121, 122 (D. Minn. 1983).

15. *Id.*

16. *Id.*

17. 11 U.S.C. § 101(13) (1979).

18. 1 COLLIER, *supra* note 12.

19. *See, e.g., Meredith v. Thralls*, 144 F.2d 473, 475 (2d Cir.), *cert. denied*, 323 U.S. 758 (1944); *In re Realty Assoc. Sec. Corp.*, 56 F. Supp. 1007 (E.D.N.Y. 1944).

20. *See, e.g., In re Daig Corp.*, 799 F.2d 1251 (8th Cir. 1986); *In re Gray*, 64 Bankr. 505 (Bankr. E.D. Mich. 1986); *In re Philadelphia Athletic Club*, 20 Bankr. 328 (E.D. Pa. 1982).

21. 11 U.S.C. § 101(13)(E) (1979).

the disqualification of a disinterested professional.²² If a court finds that the attorney or professional to be employed has had associations with the debtor which might make him or her interested, the court may reject that person even though those associations do not come strictly within the purview of Section 101(13).²³ Section 101(13), subsection (E) of the definition of disinterested persons may be viewed as a catchall provision. By failing to define adverse interest, the subsection allows courts to use subsection (E) as a safety-valve to find a would-be debtor's attorney lacking in disinterestedness for reasons other than those enumerated in the non-exclusive statutory guidelines.²⁴

Since the Code itself provides no insight into the possibility that an attorney may be jeopardizing dismissal of all fees incurred in the bankruptcy case because he or she is not disinterested, attorneys would benefit by keeping abreast of recent case law on the subject. A survey of the case law on this issue follows.²⁵

A recent Eighth Circuit decision, *In re Pierce*,²⁶ is a paradigm case which illustrates the need for attorneys to remain aware of recent court interpretations of Section 327. In *Pierce*, the court held that an attorney who is owed pre-petition fees is not "disinterested."²⁷ In the case, the debtors employed the attorney to recover on a crop insurance policy. Shortly thereafter, the attorney began to prepare the debtors' bankruptcy petitions. To secure payment for his work on the bankruptcy case, the attorney obtained an \$8,000 mortgage on real estate owned by the debtors. The Eighth Circuit held that as to the bankruptcy-related fees, the attorney would be denied fees because he was a pre-petition creditor of the debtor, and thus did not meet the definition of a "disinterested person" under Section 327(a).²⁸

The court implied that disclosure of the mortgage would not have

22. *In re Philadelphia Athletic Club*, 20 Bankr. 328 (E.D. Pa. 1979).

23. *In re Roberts*, 46 Bankr. 815, 828, 840-42 (Bankr. D. Utah 1985) cites the following cases which do not expressly fall within the provisions of § 101(13) where a conflict of interest was found to exist: *In re WPMK, Inc.*, 42 Bankr. 157 (Bankr. D. Haw. 1984) (debtor's attorney received undisclosed fee payments from the debtor's principal and investors who were creditors and who were promised reimbursement for their contributions upon the court's approval of the attorney's fee application); *In re Cropper Co.*, 35 Bankr. 625 (Bankr. M.D. Ga. 1983) (associate of the law firm that represented the debtor owns 38% of the stock of a company that had arranged, post-petition, to buy goods from the debtor on credit, in exchange for the debtor buying the goods from a supplier for cash); *In re Smith*, 5 Bankr. 92 (Bankr. D.C. 1980) (attorney for debtor also represented the debt consolidation agency that referred the debtor to the attorney).

24. *Philadelphia Athletic Club*, 20 Bankr. at 334.

25. This sampling of case law is not intended to serve as a complete guide to the complexities involved in interpreting § 327 of the Code, but rather is intended to increase awareness so that the practicing attorney will be better equipped to recognize potential conflicts.

26. 809 F.2d 1356 (8th Cir. 1987).

27. *Id.* at 1367.

28. *Id.*

changed the result in this case.²⁹ The court noted that the attorney's fees could have been denied on three separate grounds in this case.³⁰ One cause for denying compensation would be the attorney's violation of the disclosure requirements embodied in Section 328(a) and Bankruptcy Rule 2014(a). Second, the court could have denied fees by concluding that the attorney's pre-petition mortgage on the debtor's real estate constitutes an "adverse interest" under Section 327(a).³¹ The third ground for denial of fees, failure to meet the "disinterested person" requirement, was the basis for the Eighth Circuit's final holding.³²

The consequences of the *Pierce* case could be staggering. Imagine a small law firm that has spent hundreds of hours working on a reorganization plan for its largest client only to find that its efforts will not be rewarded because of either some adverse interest, no matter how obscure, or because the debtor owes the firm for pre-petition services rendered. *Pierce* is an extension of the Eighth Circuit's ruling *In re Daig Corp.*³³ In *Daig*, a management consulting firm was determined not to have met the "disinterested person" requirement by virtue of the firm's receipt of an unapproved stock purchase warrant³⁴ from the debtor. Shortly after the debtor, Daig, entered bankruptcy it hired the consulting firm, Merrimac, as a management consultant. In addition to compensation of \$1,500/week, Merrimac received a five year warrant to purchase 15% of Daig's common stock at one cent per share. The Bankruptcy Court of the District of Minnesota authorized Daig's employment of Merrimac, but reserved all questions in regard to the terms of retention and compensation. The court later limited Merrimac's compensation because the debtor, Daig, had given Merrimac a warrant. The court explained that warrant holders are included in the Code definition of equity security holders.³⁵ To be disinterested, a person or entity cannot hold an equity security.³⁶ Therefore, a warrant holder is not a disinterested person and the court may apply Section 328(c) to deny allowance of compensation for a professional who is not a disinterested person at any time during the employment by the debtor.

The Eighth Circuit's strict interpretation of the "disinterested" standard would appear to overrule the case of *In re Heatron*.³⁷ That case had been

29. *Id.* at 1363.

30. *Id.*

31. This is in accord with the holding of *In re Martin*, 62 Bankr. 943 (D. Me. 1986). In *Martin*, the law firm representing the debtor received a mortgage on the debtor's property in lieu of a retainer. The court found that a potential conflict existed so that the law firm was not "disinterested." *Id.* at 948.

32. 809 F.2d at 1363.

33. 799 F.2d 1251 (8th Cir. 1986).

34. A warrant is defined as an option to purchase shares of stock at a fixed price. *Id.* at 1253 (citing 4 FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8967, at 70 (1985)).

35. 11 U.S.C. § 101(15)(c) (1979).

36. 11 U.S.C. § 101(13)(a) (1979).

37. 5 Bankr. 703 (W.D. Mo. 1980).

heavily cited in support of the argument that, merely because a law firm is a creditor of the debtor, the attorney is not necessarily barred from representing the debtor and collecting fees. In *Heatron*, the attorney representing the debtor in possession had represented the debtor prior to the filing and as a result of the pre-petition services was one of the ten largest creditors of the estate. The court found that the attorney's status as a major creditor would not cause the attorney's disqualification when it was the debtor in possession, cloaked in the powers of the trustee, who proposed to hire the attorney.³⁸

The court reached its conclusion by attempting to reconcile Sections 327(a) and 1107(b) of the Code in a manner that would allow the attorney-creditor to continue representing the debtor. Section 1107(b) states that "notwithstanding § 327(a) of this title, a person is not disqualified for employment under § 327 of this title by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case."³⁹ The court, without analysis or explanation, determined that Section 1107(b) creates a distinction between the hiring of an attorney as representative of the trustee generally versus the hiring of an attorney to assist the debtor in possession.⁴⁰ The court reasoned that an attorney's status as a creditor of the estate is less significant when his service to the estate is merely a continuation of services provided to the debtor prior to the filing.⁴¹ The court cited no authority nor were there any policy reasons for this distinction.

In an attempt to rationalize its holding, the court in *Heatron* applied a balancing test in its decision to allow the attorney-creditor to represent the debtor. The court considered that the attorney who represented the debtor prior to the filing of the petition was most familiar with the debtor's problems, and that retention of the debtor's pre-bankruptcy attorney is most efficient, economical, and generally in the best interests of the estate.⁴² Against these factors, the court weighed whether the attorney's status as a creditor actually put the attorney in a position adverse to the estate.⁴³ Using a rather simplistic analysis, it determined that an unsecured creditor is not adverse to the estate because the unsecured creditors stand to profit from a successful reorganization plan.⁴⁴ According to the *Heatron* court, the best interest of the debtor and

38. *Id.* at 705.

39. 11 U.S.C. § 1107(b) (1979). *See supra* note 5.

40. 5 Bankr. at 705. The court states that "[t]he language of Section 327(b), when taken with the proviso in Section 1107(b), creates a distinction between the hiring of an attorney as representative of the trustee generally and the hiring of an attorney to assist in the operation of the business." *Id.* This distinction was not clarified. Moreover, the court failed to reconcile this conclusion with their prior acknowledgment that "[s]ection 1107, Title 11, U.S.C., gives the debtor in possession the same rights and powers as a trustee, with certain exceptions not relevant here." *Id.* at 704.

41. 5 Bankr. at 705.

42. *Id.*

43. *Id.*

44. *Id.*

the unsecured creditor will always be identical.⁴⁵ However, the converse is often the case. For example, an attorney-creditor may favor a sale that is advantageous from the point of view of the creditors and the debtor may be trying to save his business and opt for a marginal plan of reorganization so that the business may continue.⁴⁶

While the *Heatron* approach may seem more equitable than the denial of all attorneys fees when no actual conflict exists, the decision ignores the clear, unambiguous language of the Code and the contrary case law in this area. Section 327(a) plainly states that a "disinterested" person may not be employed, and "disinterested person" is expressly defined in § 101(13)(A) as including creditors.⁴⁷

Other courts have rejected the *Heatron* argument that Section 1107(b) is a safe harbor for attorney-creditors.⁴⁸ The better reasoned opinions hold that Section 1107(b) will not prevent the disqualification of attorneys (whether the attorney is representing the trustee or the debtor in possession) when the attorney is not a disinterested person without an adverse interest.⁴⁹ Just because an attorney has represented the debtor in prior matters not relating to the bankruptcy, the attorney is not immune from the requirements of Section 327(a).⁵⁰

The court in *In re Anver*⁵¹ explained that in accordance with Section 1107(b), an attorney is not to be disqualified *solely* on the basis of her employment by or her representation of the debtor. The court further affirmed that counsel was certainly not being disqualified solely because of prior representation of the debtor.⁵² The attorney in the *Anver* case attempted unsuccessfully to present the same argument as the court followed in *Heatron*.⁵³ That is, the attorney proposed that Section 1107(b) applies to totally eliminate the disinterested person requirement in cases where a debtor in possession rather than a trustee employs an attorney.⁵⁴ *Anver* rejected this "tortured interpretation" and applied ordinary rules of statutory construction to determine the true meaning of Section 1107(b), as it relates to the requirements of Section 327(a).⁵⁵ "The statute should be interpreted as written, unless the language is

45. *Id.* The court stated that an unsecured creditor stands to lose a great deal in liquidation; thus, the unsecured creditor is aligned with the debtor in supporting a reorganization plan.

46. *In re Anver Corp.*, 44 Bankr. 615 (Bankr. D. Mass. 1984).

47. 11 U.S.C. §§ 327(a), 101(13)(A) (1979).

48. *See, e.g., In re Roberts*, 75 Bankr. 402, 408 (D. Utah 1987); *In re Anver Corp.*, 44 Bankr. 615 (Bankr. D. Mass. 1984); *In re B.E.T. Genetics, Inc.*, 35 Bankr. 269 (Bankr. E.D. Cal. 1983).

49. *In re Anver Corp.*, 44 Bankr. 615, 618 (Bankr. D. Mass. 1984).

50. *Id.*

51. 44 Bankr. 615 (Bankr. D. Mass. 1984).

52. *Id.* at 616.

53. 5 Bankr. at 705.

54. 44 Bankr. at 616.

55. *Id.* at 616-17 ("Counsel's conclusion that the section applies to totally exclude the 'disinterested person' requirement in cases where a debtor in possession,

ambiguous or would produce an absurd result."⁵⁶ The language of both Sections 327(a) and 1107(b) is plain and unambiguous. The intent of the two sections is equally clear. The disinterested person requirement of Section 327 promotes the general policy that a professional should be free of the slightest personal interest which might color their judgement or influence their decision-making ability.⁵⁷

Section 1107(b) states that prior representation of a debtor, standing alone, is insufficient reason to ban the employment of an attorney.⁵⁸ Section 1107(b) was left unamended by the 1984 Bankruptcy Amendments. Both case law⁵⁹ and congressional intent⁶⁰ indicate that Section 1107(b) was not intended to operate as a blanket exception to the requirements of Section 327(a). Congress deliberately chose to place both the disinterested standard as well as the adverse interest standard on the debtor in possession when it enacted the new Code.⁶¹

The weight of authority agrees that Section 1107(b) does not excuse attorneys from compliance with the requirement that the attorney be a disinterested person.⁶² The issue to be resolved in each case is not whether a particular attorney or law firm is disqualified solely because of previous employment by the debtor. Rather, the issue is whether the attorney should be disqualified because he or she is not a disinterested person as that term is defined in the Code or because the attorney holds an interest adverse to the estate.⁶³

The *Heatron*⁶⁴ case, holding that an attorney may be both creditor and counsel of the debtor, seems to be an aberration, though it is often authoritatively cited. Assuming that *In re Pierce*⁶⁵ places the Eighth Circuit into the

rather than a trustee, employs an attorney, requires a tortured interpretation which the court cannot accept.").

56. *Id.* at 617.

57. 1 COLLIER, *supra* note 12.

58. *See supra* note 5 and accompanying text.

59. *See supra* note 48.

60. The legislative history of § 1107(b) may be found in S. REP. NO. 989, 95th Cong., 2d Sess. 116, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5902. The history of this provision indicates that the debtor-in-possession has the identical duties of a trustee (except investigative duties). *Wolf v. Weinstein*, 372 U.S. 633, 649-50 (1963), was cited as an example of a pre-Code Chapter X case where a debtor's counsel who traded in the debtor's stock was disqualified.

61. *In re Leisure Dynamics*, 32 Bankr. 753, 755 (D. Minn. 1983). An additional indication exists that the disinterested provision was intended by Congress to apply to attorneys employed by debtors in possession. Under former Bankruptcy Rule 215 of the old Bankruptcy Act only the adverse interest standard was applied for disqualification of an attorney of the debtor in possession. By eliminating this provision of Rule 215 when it enacted the new code, Congress deliberately chose to place both the "disinterested person" and the "adverse interest" constraints on the debtor in possession.

62. *See, e.g., In re Patterson*, 53 Bankr. 366, 372 (Bankr. D. Neb. 1985) (quoting 1 W. NORTON, BANKRUPTCY LAW AND PRACTICE § 13.26, at 41 (1981)).

63. *In re B.E.T. Genetics*, 35 Bankr. 269, 272 (Bankr. E.D. Cal. 1983).

64. *In re Heatron, Inc.*, 5 Bankr. 703, 705 (W.D. Mo. 1980).

65. 809 F.2d 1356, 1362 (8th Cir. 1987).

mainstream by recognizing that an attorney cannot play the dual roles of attorney and creditor, what are the implications for the practicing bar?

The significance of the *Pierce* case is that if a debtor, on the date the petition for bankruptcy is filed, owes an attorney or law firm a pre-petition debt for legal services not rendered in contemplation of or in connection with the bankruptcy case, the attorney and/or the law firm is a creditor of the debtor to the extent of those fees. Consequently, because Section 327 requires the attorney to be disinterested, attorneys owed fees must choose between waiving the pre-petition fee claim or referring the Chapter 11 case to another attorney.

The first step in preventing this dilemma caused by *Pierce*, is to be cognizant of those situations in which a potential conflict might arise by remaining aware of the developing decisional law in this area.⁶⁶

The next step is to determine what, if anything, an attorney may do to prevent having spent countless hours on a bankruptcy case only to find that a conflict has made the work pro bono. There is authority which suggests that so long as an attorney discloses all prior involvement with the debtor pursuant to Rule 2014,⁶⁷ most conflict problems may be resolved.⁶⁸

Some courts take the approach that nondisclosure of information pertaining to the attorney-clients relationship and fee arrangement should be considered as only one factor in determining whether to deny compensation.⁶⁹ Only when failure to disclose a prior relationship is combined with other attorney misconduct does the attorney "get what he deserves" and not get paid. Other

66. Conflicts of interest in the bankruptcy context are certainly not limited to those cases where an attorney is a creditor of the debtor, although that factual situation is the focus of this Comment. For an in-depth scholarly opinion of other types of conflicts in bankruptcy cases, see *In re Roberts*, 46 Bankr. 815 (Bankr. D. Utah 1985), *rev'd in part*, 75 Bankr. 402 (D. Utah 1987).

67. BANKR. R. P. 2014 provides that such disclosure is mandatory. The problem is recognizing what type of dealings or former contact with the debtor should be disclosed, and to what extent disclosure should be made under this rule.

68. Full disclosure prevents conflict problems by allowing a fully informed court to decide whether to allow a firm in a potential conflict situation to represent the debtor. If the court makes a well-founded decision to disqualify the firm, post-petition fees cannot be incurred or subsequently denied. *In re Rogers-Pyatt Shellac Co.*, 51 F.2d 988, 992 (2d Cir. 1931); *In re Gray*, 64 Bankr. 505, 508 (Bankr. E.D. Mich 1986).

69. *In re Michigan Gen. Corp.*, 78 Bankr. 479, 483 (Bankr. N.D. Tex. 1987) (court stated that failure to disclose was an important aspect of the case but declined to answer whether the holding would have been different if disclosure had been made); *In re Roberts*, 75 Bankr. 402, 410-13 (Bankr. D. Utah 1987) ("where the equities outweigh the need for attorney discipline for failure to disclose potential conflicts, the law does not require the denial of fees and costs"); *In re B.E.T. Genetics*, 35 Bankr. 269, 273-74 (Bankr. E.D. Cal. 1983) (court states that several factors are present to support a finding that the law firm there was disinterested - one of the enumerated factors was the firm's failure to disclose information). It is worth noting that some courts tend to relax the rule denying all compensation in Chapter 11 cases. *In re GHR Energy Corp.*, 60 Bankr. 52, 68 (Bankr. S.D. Tex. 1985).

courts follow the extreme position that nondisclosure of any relevant information regarding an attorney's application for employment is, without more, grounds for the denial of fees.⁷⁰ Theoretically, attorneys could be denied fees even where no actual or potential conflict exists - merely an omission of any prior contact with the debtor could suffice as a violation of the disclosure requirement under this harsh construction of the rule.

The Code and Bankruptcy Rules, as well as in compliance with the provisions of the Code of Professional Responsibility, establish that attorneys who seek employment under Section 327 of the Code and who are aware they may be involved in actual or potential conflicts of interest, must disclose those facts to the court.⁷¹ Attorneys are bound by duty to completely disclose all facts bearing upon their eligibility for appointment in a bankruptcy case. An innocent omission is no excuse.⁷² Likewise, ignorance of relevant factors is unjustifiable.⁷³

The duty of an attorney seeking employment in a bankruptcy case arises from the fiduciary obligation owed by counsel for the debtor to the bankruptcy court.⁷⁴ Because attorneys who seek compensation for services or reimbursement of expenses do so as officers of the court, they are held to fiduciary standards.⁷⁵ The Bankruptcy Court itself is under no obligation to search the file to determine whether a prospective attorney is involved in actual or potential conflicts of interest.⁷⁶ This is the responsibility of the attorney.

One purpose of the disclosure requirements is to assure that the appointed attorney will not be adjudged as disqualified and/or ineligible to collect a fee because he is not disinterested.⁷⁷ However, a liberal reading of the Code provides no guarantees that an attorney will receive his fees, even if his employment is initially approved by the court. Section 328(c) of the Code allows the court to deny allowance of compensation, "if, at any time . . . such professional person is not a disinterested person, or represents or holds an interest

70. *In re Pierce*, 809 F.2d 1356 (8th Cir. 1987); *In re Futuronics Corp.*, 655 F.2d 463, 469 (2d Cir. 1981); *In re Haldeman Pipe & Supply Co.*, 417 F.2d 1302, 1304 (9th Cir. 1969); *In re Thompson*, 54 Bankr. 311, 316 (Bankr. N.D. Ohio 1985); *In re Guy Apple Masonry Contractor, Inc.*, 45 Bankr. 160, 163 (Bankr. D. Ariz. 1984); *In re Devers*, 33 Bankr. 793, 799 (Bankr. D.D.C. 1983); *In re Coastal Equities, Inc.*, 39 Bankr. 304, 307-09 (Bankr. S.D. Cal. 1981).

71. *In re Roberts*, 46 Bankr. 815 (Bankr. D. Utah 1985), *rev'd in part*, 75 Bankr. 402 (D. Utah 1987).

72. *In re Arlan's Dep't Stores*, 615 F.2d 925, 933 (2d Cir. 1979) ("If that duty [disclosure] is neglected, however innocently, surely they [the attorney] should stand not better than if it had been performed.") (quoting *In re Rogers-Pyatt Shellac Co.*, 51 F.2d 988, 992 (2d Cir. 1931)).

73. See, e.g., *In re Marine Power & Equip. Co.*, 67 Bankr. 643, 654 (W.D. Wash. 1986).

74. *Arlan's Dep't Stores*, 615 F.2d at 937.

75. *Coastal Equities*, 39 Bankr. at 309.

76. *Roberts*, 46 Bankr. at 839.

77. See Flowers, *Attorney Fees: Handling Bankruptcies Without Getting There Yourself*, 64 W. VA. L. REV. 671 (1982).

adverse to the estate with respect to the matter on which such professional person is employed."⁷⁸

It is unsettling to know that the court has the power at any time to deny the fees which an attorney has worked very hard to earn in a bankruptcy case. Just ask the attorneys in the *In re 765 Associates*⁷⁹ case. They were not only denied fees, but were ordered to reimburse the estate for fees already received when a conflict was found. The approach in *In re 765 Associates* is at the opposite extreme from the *Heatron*⁸⁰ case. While *765 Associates* required the attorneys to repay the debtor's estate when a nondisclosed conflict of interest existed, the *Heatron* court ignored that an attorney-creditor's interest may not always be coterminous with the debtor's best interests.⁸¹ There must be some middle ground that would allow the court to balance the competing policy considerations entangled within § 327.

Bankruptcy courts are courts of equity.⁸² Equity contemplates fairness, practicability, and workability in fashioning remedies.⁸³ The reality is that it is not uncommon for a debtor to be indebted to his attorney on the date the bankruptcy petition is filed.⁸⁴ Is it fair to an attorney who has successfully brought a debtor through a reorganization plan to be admonished rather than applauded for his efforts because a purely hypothetical conflict exists? Common sense answers no. Certainly, even courts of equity must follow the rules that Congress has laid down. But such courts are not required to follow the rules blindly. Bankruptcy courts, as courts of equity, "should have the ability to deviate from [the rules] in those cases in which the need for attorney discipline is outweighed by the equities of the case."⁸⁵ The court in *In Re Roberts*⁸⁶ aptly described the dilemma;

when dealing with ethical principles, . . . we cannot paint with broad strokes. The lines are fine and must be so marked. Guide posts can be established when virgin ground is being explored and the conclusion in a particular case can be reached only after a painstaking analysis of the facts and precise application of precedent.⁸⁷

Few would argue that a blanket denial of fees whenever a possible conflict

78. 11 U.S.C. § 328(c) (1979) (emphasis added).

79. 14 Bankr. 449 (Bankr. D. Haw. 1981).

80. See *supra* notes 37-47 and accompanying text.

81. See *supra* text accompanying notes 45-46.

82. *Bank of Marin v. England*, 385 U.S. 99, 103 (1966).

83. *In re Anver*, 44 Bankr. 615, 620 (Bankr. D. Mass. 1984) (citing *Lemon v. Kurtzman*, 411 U.S. 192, 200 (1973)).

84. The court in *Anver* mused that a large percentage of persons hired in bankruptcy proceedings are pre-petition creditors and wondered why the issue of conflict of interest under § 327(a) had not arisen more often. *Anver*, 44 Bankr. at 619.

85. *In re Watson Seafood & Poultry Co.*, 40 Bankr. 436, 440 (Bankr. E.D.N.C. 1984).

86. 75 Bankr. 402 (D. Utah 1987).

87. *Id.* at 405 (quoting *United States v. Standard Oil Co.*, 136 F. Supp. 345, 367 (S.D.N.Y. 1955)).

of interests exists is the ideal approach to interpreting § 327(a). The integrity of the Bankruptcy Court is of paramount concern and any appearance of wrongdoing created by a conflict of interest should be prevented. On the other hand, there are competing equities entangled within a strict interpretation of § 327(a) that should be considered. The courts should take into account the plight of the debtor going through bankruptcy proceedings. "Most debtors can't afford one attorney, let alone two."⁸⁸ Disqualification of the debtor's attorney means the debtor must incur the expenses associated with retaining a new attorney. The debtor is unlikely to understand why he is being forced to seek new counsel at such an economically and often emotionally devastating time. This turn of events is likely to produce just what the rule was intended to prevent - undermined public confidence in the bankruptcy system. Reorganization plans are often quite complex; the newly appointed attorney will likely spend numerous hours just acquainting himself with the case. Bankruptcy proceedings will be delayed. Ultimately, it will be the creditors who pay because the bankruptcy estate will be depleted by the attorney's fees.

A literal reading of § 327(a) will not only cause the debtor delay and expense, but may also deprive the debtor of highly qualified counsel of his own choosing. The effect a potential conflict of interest has on the debtor's right to counsel of his choice has been recognized as an important consideration (at least by the courts outside of the bankruptcy system) in determining whether counsel should be disqualified.

In the seminal case on conflict of interests, *Woods v. City National Bank and Trust Company of Chicago*,⁸⁹ the Court observed a need to maintain a balance between prohibiting the unethical conduct of attorneys and other social interests including a litigant's right to freely chosen counsel. The court in *Emle Industries*⁹⁰ reiterated the concerns expressed in *Woods*: "[We are] conscious of our responsibility to preserve a balance, delicate though it may be, between an individual's right to his own freely chosen counsel and the need to maintain the highest ethical standards of professional responsibility."⁹¹

Neither *Woods* nor *Emle* involve a bankruptcy proceeding. Maybe that is why the bankruptcy courts have felt unobliged to balance the debtor's right to counsel of choice when disqualifying attorneys under Section 327(a). Or perhaps the courts believe that Congress has already performed this balancing test. One court has stated that "when [Congress] enacted § 327(a), [it] made a choice that efficiency would be sacrificed for the appearance of propriety."⁹² Presumably, other factors such as the debtor's right to decide who shall represent him were sacrificed (if not ignored) when Congress promulgated Section 327(a). Surely if the rights of the debtors, creditors and attorneys had in

88. *In re Freedom Solar Center, Inc.*, 49 Bankr. 996 (D. Me.), *rev'd*, 776 F.2d 14 (1st Cir. 1985).

89. 312 U.S. 262 (1941).

90. *Emle Indus. v. Patentex, Inc.*, 478 F.2d 562 (2d Cir. 1973).

91. *Id.* at 564-65.

92. *In re Gray*, 64 Bankr. 505, 508 (Bankr. E.D. Mich. 1986).

fact been balanced against the bankruptcy court's need for the appearance of propriety, a more functional solution regarding the application of Section 327(a) would have emerged.

The commentators and practitioners have taken varied approaches to alleviating the problems created by Section 327(a). Clearly, any possible conflict of interest can *not* be solved by the debtor paying the attorney the debt owed for pre-petition work just prior to filing the bankruptcy petition. Such a transfer could be voided as a preference⁹³ if made within 90 days of the bankruptcy filing. An attorney might avoid the conflict of interest problem if they encourage all clients who foreseeably might file bankruptcy in the next few months to stay current in their payment of attorneys fees, and not hold a past due account. Unfortunately, attorneys are not clairvoyant and cannot predict with certainty which of their clients will end up in bankruptcy. Also, since bankruptcy proceedings do not occur in a vacuum, the debtor has often been involved in adversarial proceedings prior to the bankruptcy which either led to or contributed to the debtor's financial demise. When an adversarial action precedes bankruptcy, the likelihood that the debtor will owe the attorney for services already rendered increases. Financially distressed clients are unlikely to be able to negotiate a "cash and carry" plan for an attorney's services.

An attorney may be forced to make a Hobson's choice: Waiving all pre-petition debts at the outset of the bankruptcy case so the attorney will be eligible for employment under § 327(a) or refusing to represent his client in bankruptcy proceedings because a potential conflict of interest exists.

A less ethical solution has reportedly been employed by at least one firm (hereinafter referred to as Firm "X").⁹⁴ Firm "X" uses a straw party to avoid the quandary caused by § 327(a). Firm X has had a number of clients who owed the firm money for pre-petition work and later sought the services of the firm to initiate bankruptcy proceedings. Rather than decline their services, Firm X hired Firm Y, a second firm, to act as a straw party. Firm Y's only responsibility is to complete an application for employment and act as attorney of record, so that the potential conflict problems caused by the debt owed to Firm X would not be revealed. Firm X actually completes the majority of the work on the case and is reimbursed from the fees received by Firm Y (of course Firm Y would have to make all court appearances). Certainly this is unethical, if not unlawful.⁹⁵

93. See, e.g., *In re Crisp*, 64 Bankr. 351, 353 (Bankr. W.D. Mo. 1986) ("[T]he conflict of interest would not be eliminated if the law firm obtained from the client a pre-petition payment of these fees and costs because such a payment would likely constitute a preference that may be avoided for the benefit of other creditors. . . .") (quoting *In re Roberts*, 46 Bankr. 815, 849 (Bankr. D. Utah 1985)).

94. The author was unable to determine the name of this firm or verify if this tactic was in fact being used to deceive the bankruptcy court.

95. *In re Matis*, 73 Bankr. 228, 230 (Bankr. N.D.N.Y. 1987) noted that "a fee sharing arrangement between attorneys wherein one party simply referred the case to the other and performed no actual services was now not entitled to share in any com-

A more ethical, prophylactic system is proposed by D. Kent Meyers, in his article on ethical considerations in representing multiple creditors.⁹⁶ Meyers suggests six ways to avoid conflict of interest problems, such as those created by § 327(a). They are as follows:

1. Each lawyer or law firm should make a formal commitment to abide by the highest ethical standards. This commitment can be implemented in a partnership agreement or as part of the written office policy, and developed by encouraging active participation on local, state, or national bar committees on professional responsibility.⁹⁷
2. An intra-firm Professional Responsibility Committee is recommended to conduct intra-firm training and to resolve and avoid firm conflict problems.⁹⁸
3. The Code of Professional Responsibility should be re-emphasized in the training of new associates and lay personnel.⁹⁹
4. Professional employment data should be circulated throughout the firm to "raise conflict of interest 'red flags'."¹⁰⁰
5. An attorney or law firm should candidly discuss the firm's conflict of interest policy and any potential problems that could arise with their clients.¹⁰¹
6. A new local bankruptcy rule which provides that:

In addition to any requirements of other applicable statutes or rules, any person representing more than one creditor shall file a signed statement with the court setting forth that:

- (1) The multiple representation has been disclosed to each such creditor;
- (2) The actual or potential conflict of interest has been discussed with each such creditor;
- (3) Each such creditor has agreed to the multiple representation;
- (4) The signor shall advise all such creditors and the court should any material change take place that disqualifies the signor from continuing the multiple representation.¹⁰²

A practical solution was suggested by the court in the *Roberts* case.¹⁰³ The *Roberts* court proposed applying a balancing test, weighing the need for attorney discipline against other factors such as the conduct of the attorney in this particular case, the success of the reorganization plan, and the absence of complaints from other creditors.¹⁰⁴ This case-by-case approach is much more flexible than *Pierce*¹⁰⁵ and the line of cases that unconditionally deny fees

pensation paid by the bankrupt." *Id.* Conversely, it would seem that the party to whom the case was referred, the "straw party", would not be entitled to compensation, resulting in a denial of fees to "Firm X" in the situation described in the text.

96. Meyers, *Ethical Considerations in the Representations of Multiple Creditors Against a Single Debtor*, 51 AMER. BANKR. L.J. 19 (1977).

97. *Id.* at 26.

98. *Id.* at 27.

99. *Id.*

100. *Id.* at 28.

101. *Id.*

102. *Id.* at 28-29.

103. *In re Roberts*, 75 Bankr. 402 (D. Utah 1987).

104. *Id.* at 412-13.

105. *See supra* text accompanying notes 25-31.

when a potential conflict exists. *Roberts* is also one of the few bankruptcy cases that closely approximates the standards set by the Model Code of Professional Responsibility. Only a few of the bankruptcy cases involving conflicts of interest even give lip service to the rules of Professional Responsibility. Generally, the courts have noted that their decisions would have been no different under the Code of Professional Responsibility as if the similar results have occurred by coincidence rather than compulsion.¹⁰⁶

It appears that different standards of conduct are being applied in and out of the Bankruptcy Courts.¹⁰⁷ This may be due in part to the fact that conflicts of interest are more prevalent in bankruptcy cases.¹⁰⁸ For whatever reason, the trend is to treat conflict of interest problems more seriously when they arise in a bankruptcy court. The ABA Code of Professional Responsibility, Canon 9 is entitled "A lawyer should avoid even the appearance of impropriety." "[U]nder this canon there must be a showing of a reasonable possibility that some specifically identifiable impropriety in fact occurred and that the likelihood of public suspicion must be weighed against the interest in retaining counsel of one's choice."¹⁰⁹ In contrast, the bankruptcy courts do not require either a likelihood of some specific injury or a balancing test.¹¹⁰ All that must be shown is that a potential conflict exists.¹¹¹

Attorneys should not be subjected to more stringent ethical standards when they enter the bankruptcy courtroom. "The very concept of a professional ethic precludes the varying of ethical principles when applied to different areas of the law."¹¹² Applying more rigid ethical standards to attorneys practicing in bankruptcy courts could foster the belief that bankruptcy pro-

106. See, e.g., *In re Michigan Gen. Corp.*, 78 Bankr. 479, 484 (Bankr. N.D. Tex. 1987); *In re Marine Power & Equip. Co.*, 67 Bankr. 643, 648 (Bankr. W.D. Wash. 1986); *In re B.E.T. Genetics, Inc.*, 35 Bankr. 269, 271 (Bankr. E.D. Cal. 1983); *In re Philadelphia Athletic Club*, 20 Bankr. 328, 335 (E.D. Pa. 1982).

107. An in-depth comparison of the courts' treatment of conflicts of interest under the Model Code of Professional Responsibility as compared to the Bankruptcy Code is beyond the scope of this Comment. For a more complete discussion of this comparison, see Stranko, *Attorney Conflicts of Interest in Bankruptcy Proceedings*, 9 J. LEGAL PROF. 229 (1984).

108. Stranko, *supra* note 107, suggests that the drafters of the Bankruptcy Reform Act increased the potential for conflict problems by delegating more responsibility to debtor's attorneys. *Id.* at 230-31. As a practical matter, bankruptcies involve more parties than the typical adversarial action with a single plaintiff and defendant. The likelihood that an attorney may have an "adverse" interest or is not "disinterested" increases as the number of parties involved increases.

109. *Brennan's, Inc. v. Brennan's Restaurants*, 590 F.2d 168, 172 (5th Cir. 1979).

110. See, e.g., *In re Marine Power & Equip. Co.*, 67 Bankr. 643, 653 (Bankr. W.D. Wash. 1986) (a court may deny compensation even in the absence of an actual conflict of interest).

111. See, e.g., *Roger J. Au & Son, Inc. v. Aetna Ins. Co.*, 64 Bankr. 600, 606 (N.D. Ohio 1986) (even a possibility of a conflict may warrant disqualification).

112. Stranko, *Attorney Conflicts of Interest in Bankruptcy Proceedings*, 9 J. LEGAL PROF. 229, 229 (1984).

ceedings and bankruptcy attorneys need closer scrutiny.

One court indicated its dissatisfaction with a literal interpretation of Section 327(a), but stated that it was bound to interpret the section as written until Congress lends a hand to either interpret or rewrite Section 327(a).¹¹³ Until that time comes, attorneys should be aware that general principles of what constitutes a conflict of interest may not hold true in the bankruptcy court. The issue of just what type of relationship between debtor and his attorney will create a conflict in the context of bankruptcy proceedings is not yet clear. The cases cited throughout this article do not establish any solid guidelines to provide comfort to the practicing attorney who expects to be paid for his services. Rather, these cases should act as a caution light, signaling attorneys to proceed with care whenever a former client asks for representation in a bankruptcy matter. The best course of action is to err on the side of caution and disclose even the most remote associations between the debtor and the attorney or the attorney's firm, as well as disclosing all past, present, and future fee arrangements. Any embarrassment from disqualification at the outset of a case is certainly preferable to discovering a conflict or adverse interest well into the case when the financial impact of an order denying all fees may be devastating.

Finally, experienced bankruptcy attorneys should not be lulled into a false sense of security because they have ignored the requirements of Section 327(a) in the past without sanctions or comment. The conflict of interest problems caused by Section 327(a), especially the situation where the attorney is a creditor of the debtor by way of unpaid pre-petition attorneys fees, are not just academic. Although the majority of courts have overlooked this problem area in the past, the trend set by recent cases like *Pierce* is to strictly interpret Section 327(a) and deny attorney fees whenever the attorney is not "disinterested" or contains an interest adverse to the estate.

PATTI WILLIAMS

113. See, e.g., *In re Anver Corp.*, 44 Bankr. 615, 619 (Bankr. D. Mass. 1984).