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On the Edge

By Jerald I. Ancel and Jeffrey J. Graham

Renewed Interest in Disinterestedness under §§ 101(14) and 327(a)

Jerald I. Ancel
Taft Stettinius & Hollister LLP Indianapolis

Jeffrey J. Graham
Taft Stettinius & Hollister LLP Indianapolis

Jerald Ancel and Jeffrey Graham are partners in Taft Stettinius & Hollister LLP's Indianapolis office. Mr. Ancel is also co-chair of the firm's Business Restructuring, Bankruptcy and Creditors' Rights Groups and serves as a coordinating editor for the ABI Journal.

The changing landscape of the legal market has increased law firm mergers, and acquisitions this year are on a pace to surpass the previous high experienced in 2008.[1] In addition to the market consolidation, commercial chapter 11 filings have continued to decline.[2] As the insolvency bar and financial advisory firms consolidate and reshuffle rosters, some known and long-forgotten ethical and statutory disinterestedness issues have begun to surface.

Ethical and Statutory Framework for Employment by the Estate

Generally, a lawyer or firm may not represent a new client in a matter (1) that is materially adverse to a former client; (2) that is substantially related to the matter for which the lawyer or firm was engaged by the former client; or (3) where confidential information learned in the previous engagement may be used against a former client.[3] Similarly, a lawyer may not represent a new client in a matter that is directly adverse to another client.[4] However, those general rules can be overcome by an informed waiver by both the new client on the one hand and the former or current client on the other, coupled with a screening procedure to wall off the conflicted lawyer.[5] These rules of professional conduct apply to all insolvency lawyers.[6]

Insolvency professionals seeking compensation from the estate must go above and beyond mere conflict checks. Many courts hold that a professional is disqualified under § 327(a) of the Bankruptcy Code in the event of a direct conflict regardless of a waiver.[7]

In addition, § 327(a) requires that a professional seeking compensation from the estate have no interest adverse to the estate and be disinterested.[8] Courts define an adverse interest as an economic interest that would (1) lessen the value of the bankruptcy estate, or (2) create an actual or potential dispute against the estate or a predisposition for bias against the estate.[9] An economic interest usually arises as a claim against the debtor. Should the professional firm have a claim and want to continue working with the client as a debtor professional, waiving the claim may remedy this potentially adverse interest.[10]

Section § 101(14) of the Bankruptcy Code defines a disinterested person as a person who (1) is not a creditor, equity securityholder or insider of the debtor; (2) is not and was not, within two years of the petition date, a director, officer or employee of the debtor; and (3) does not have any interest materially adverse to the estate, any class of creditors, or equity interests by reason of any direct or indirect relationship to, connection with, or interest in the debtor or for any other reason.[11] Federal Rule of Bankruptcy Procedure 2014 facilitates a review of disinterestedness by requiring the applicant to submit a verified statement that fully and broadly discloses any connection with the debtor, creditor, and any party-in-interest.[12] Even with the requirements of § 327(a), courts rarely interfere with a

1 *See* Press Release, Altman Weil Inc., "U.S. Law Firms on Pace for Record Year," www.altmanweil.com/MLPR70813/ (last visited July 16, 2013).
2 Press Release, ABI, "Bankruptcy Filings Fall 14 Percent for the First Half of 2013, Commercial Filings Drop 25 Percent," July 3, 2013, http://news.abi.org/press-releases/bankruptcy-filings-fall-14-percent-for-the-first-half-of-2013-commercial-filings-drop.
3 *See* Model Rules of Prof'l Conduct R. 1.9 (2013).
4 *See* Model Rules of Prof'l Conduct R. 1.7 (2013).
5 *See* Model Rules of Prof'l Conduct R. 1.10 (2013).
6 *See In re City of San Bernardino, Calif.*, Case No. 6:12-bk-28006-MJ, *slip op.* (Bankr. C.D. Cal. June 25, 2013) (firm disqualified from representing creditor in chapter 9 proceeding due to conflict of interest).
7 *See In re Jade Mgmt. Servs.*, 386 F. App'x 145, 148 (3d Cir. 2010). Courts have broad discretion in approving employment in instances of a potential conflict. *Id.*
8 *See In re Knight-Celotex LLC*, 695 F.3d 714, 722 (7th Cir. 2012).
9 *See In re AFI Holdings Inc.*, 530 F.3d 832, 845 (9th Cir. 2008), and *In re Persaud*, 467 B.R. 26, 36 (Bankr. E.D.N.Y. 2012).
10 *See, e.g., In re Dearborn Construction Inc.*, No. 02-00508, 2002 WL 31941458 at *8, fn. 23 (Bankr. D. Idaho Dec. 20, 2002).
11 11 U.S.C. §§ 101(14)(A)-(C).
12 Fed. R. Bankr. P. 2014(a); *see also In re Knight-Celotex LLC*, 695 F.3d at 722.

debtor's choice of professional, and then will do so only if (1) the professional has a conflict of interest or (2) it is clear that the professional's employment would not be in the best interests of the estate.[13] This framework has been in place for many years. However, three recent cases show that the disinterested requirement may be undergoing a more searching review and how the changing marketplace may be making compliance with these requirements more difficult.

Member's Employment Terms and Status Cause Concern

The debtor, New England Compounding Pharmacy Inc., sought to employ Verdolino & Lowey PC as its accountant and financial adviser.[14] The application and Verdolino's declaration disclosed that (1) the debtor was the subject of hundreds of lawsuits stemming from an outbreak of fungal meningitis linked to contaminated pharmaceuticals distributed by the debtor; (2) the goal of the chapter 11 filing was to channel these claims into a single forum and to distribute the assets of the estate to these claimants; (3) Verdolino's shareholder had been named the chief restructuring officer (CRO) and an independent director of the debtor and was charged with running the chapter 11 case and distributing assets to claimants; (4) the CRO was removable without cause by the debtor's board of directors; and (5) Verdolino sought to be indemnified by the debtor.[15]

The application drew an objection by the U.S. Trustee,[16] who first argued that Verdolino was not disinterested because its shareholder served as both an officer and director of the debtor.[17] Although it was the shareholder who served as an officer and director, the U.S. Trustee argued that violation of § 101(14) was imputed to the entire firm, citing *In re Essential Therapeutics Inc*.[18] The U.S. Trustee also argued that Verdolino was not disinterested because the debtor's board, which faced allegations of misconduct, was still in power and had the ability to remove the CRO at the board's sole discretion.[19] The U.S. Trustee reasoned that this retention arrangement constituted an adverse interest to the estate, which may look to the board under one or more theories of liability.[20] The court never ruled on the debtor's application to employ Verdolino and the U.S. Trustee's objection as the court appointed a chapter 11 trustee to oversee the liquidation of the debtor's assets and the trustee hired a separate set of professionals.[21]

Attorney's Lack of Disinterestedness Imputed to the Firm

In *In re Coda Holdings Inc.*, the debtor sought to employ White & Case LLP as its counsel.[22] The application to employ White & Case disclosed that (1) the firm had hired Christopher Rose, a former senior vice president and general counsel of the debtor whose responsibilities while with the debtor included financing and acquisitions; (2) White & Case had established screening procedures with respect to Rose and his assistant; (3) Rose would have no involvement in the debtor's chapter 11 case; (4) Rose would waive any claim or equity interest in the debtor; (5) White & Case had arranged for conflicts counsel in the event that the debtor had any claims against Rose; and (6) the debtor consented to White & Case's engagement based on these procedures.[23] The debtor also argued that although Rose might not be disinterested under § 101(14), his status was not imputed to White & Case, which itself was a person under § 101(41)[24] and satisfied, as a firm, the statutory requirements for disinterestedness.[25]

The U.S. Trustee objected to the application to employ White & Case, arguing that Rose's lack of disinterestedness was imputed to the entire firm.[26] This argument was based on *In re Essential Therapeutics Inc.*, a decision issued by Hon. **Mary F. Walrath** (and cited by the U.S. Trustee in *In re New England Compounding Pharmacy Inc.*), which imputed the disinterestedness of one member of a firm to the entire firm. It also distinguished the cases cited by the debtor on the grounds that Rose was the person hired to make deals, and the U.S. Trustee believed that the instant case was about a deal.[27]

The application and objection thereto were extensively briefed; however, the court issued a one-page order denying the application without prejudice.[28] The debtor subsequently sought and received authority to engage White & Case as special counsel pursuant to § 327(e) of the Bankruptcy Code, which requires that special counsel have no material interest adverse to the estate but does not contain any disinterestedness requirement.[29]

Independent Contractor with Fee Agreement Affects Counsel and Adviser

Long after GSC Group Inc. had engaged Kaye Scholer LLP as debtors' counsel and Capstone Advisory Group LLC as financial adviser and had conducted a successful § 363 sale of its assets, the U.S. Trustee sought disgorgement of all compensation earned by Kaye Scholer and Capstone and a *vacatur* of the orders approving their employment.[30] The crux of the U.S. Trustee's motion centered on Robert Manzo, his relationship with Capstone, his compensation and how the relationship was disclosed by Kaye Scholer.[31] Kaye Scholer's application and affidavit did not disclose any relationships with Manzo or any entities controlled by Manzo.[32] Capstone's application and declarations listed Manzo as an executive director, and stated that he was an employee of Capstone and that Capstone had no fee-sharing agreements.[33] However, the U.S. Trustee learned through subsequent discovery that (1) Manzo was not an employee of Capstone, but

13 *In re Smith*, 507 F.3d 64, 71 (2d Cir. 2007).
14 *In re New England Compounding Pharmacy Inc.*, No. 12-19982-HJB, Docket No. 3 (Bankr. D. Mass. Dec. 21, 2012).
15 *Id.*
16 *Id.*, Docket No. 40 (Bankr. D. Mass. Jan. 8, 2013).
17 *Id.*
18 *Id. In re Essential Therapeutics Inc.*, 295 B.R. 203, 208-11 (Bankr. D. Del. 2003). *But see* fn. 25 for cases holding the contrary.
19 *Id.*
20 *Id.* The U.S. Trustee also objected to proposed indemnification provisions.
21 *Id.*, 03-11317 MFW, Docket No. 92 (Bankr. D. Mass. Jan. 24, 2013).
22 *In re Coda Holdings Inc., et al.*, Case No. 13-11153 (CSS), Docket No. 61 (Bankr. D. Del. May 7, 2013).
23 *Id.*
24 The Bankruptcy Code defines a "person" as including an "individual, partnership and corporation." 11 U.S.C. § 101(41).
25 *Coda*, No. 13-11153 (CSS)., Docket No. 61 (Bankr. D. Del. May 7, 2013) (citing *In re Cygnus Oil and Gas Corp.*, No. 07-32417, 2007 WL 158011, at *2 (Bankr. S.D. Tex. May 29, 2007), and *In re Sea Island Co.*, No. 10-21034, 2010 WL 4386855, at *2 (Bankr. S.D. Ga. Oct. 20, 2010)).
26 *Coda*, No. 13-11153 (CSS), Docket No. 140 (Bankr. D. Del. May 24, 2013).
27 *Id.*
28 *Id.*, *slip op.* (Bankr. D. Del. May 29, 2013).
29 *Id.*, *slip op.* (Bankr. D. Del. June 17, 2013).
30 *In re GSC Grp. Inc., et al.*, No. 10-14653 (SCC), Docket No. 1597 (Bankr. S.D.N.Y. Jan. 4, 2013).
31 *Id.*
32 *Id.*
33 *Id.*

rather was an independent contractor; (2) Manzo's agreement with Capstone was actually through a limited liability company (LLC); (3) Capstone had a compensation agreement with Manzo whereby he received a hybrid of an hourly rate plus a portion of the fees generated for Capstone; (4) Kaye Scholer had done work with Manzo and his LLC; (5) members of Kaye Scholer knew that Manzo was an independent contractor and not an employee of Capstone; and (6) Manzo, for at least part of the debtors' chapter 11 cases, did not work exclusively for Capstone.[34] The U.S. Trustee argued that in light of these revelations, neither Kaye Scholer nor Capstone were disinterested, that both failed to adequately disclose their relationships with parties-in-interest, and that Capstone had a fee-sharing arrangement with someone other than a regular member, associate or employee of the firm in violation of § 504 of the Bankruptcy Code.[35]

Both Kaye Scholer and Capstone contested the allegations made and the relief sought by the U.S. Trustee.[36] Kaye Scholer and Capstone argued that any disclosure errors were inadvertent; the debtors were not harmed by these errors; the fee arrangement with Manzo did not violate § 504 because the association was not hidden, did not include a markup and Manzo did work only for Capstone; and that the professionals provided significant value to the estates, obtaining a sale price of $235 million after rejecting a stalking-horse bid of $5 million.[37]

After numerous conferences, a mediation and voluminous briefing, the parties reached a settlement wherein Kaye Scholer would either disgorge or waive approximately $1.5 million in fees, Capstone would either disgorge or waive approximately $1 million in fees and abandon a $2.75 million success fee, and both Kaye Scholer and Capstone would submit to an independent third party overseeing conflicts for a period of two years.[38] The settlement is currently awaiting court approval after the matters were argued in the context of Kaye Scholer's final fee application.

Conclusion

In view of this renewed interest in disinterestedness, what can professionals seeking compensation from the estate do to avoid disqualification or disgorgement? Lawyers must distinguish between conflicts arising under their ethical rules and being disinterested under §§ 101(14) and 327(a) of the Bankruptcy Code. Informed waivers and screening procedures might be sufficient under ethical rules but may not be enough to be deemed disinterested under the Bankruptcy Code.

Disclosure is paramount. However, proper disclosure requires good data. Not only must a professional have a robust conflicts database, but that database should include members' present and prior board memberships and prior positions held within the last two years. It is also important to understand the relationship that any member of the firm has with a party-in-interest in a chapter 11 case, something that becomes exponentially harder with larger firms. The professional should also understand any new member's prior employment, involvement with matters that could be deemed a conflict, and the new member's relationship with the debtor, creditor or party-in-interest. Attention should also be given to any member still holding an economic interest in the firm but not currently employed (*i.e.*, an equity payout).

Finally, care should be given to a professional's use of independent contractors, and such relationships must be disclosed. In addition, the professional should avoid any markup of the contractor's rates or a bonus structure based on fees generated that might be deemed to incentivize the contractor to act in its self-interest. The professional should also disclose what, if any, other engagements the contractor may have during the bankruptcy case. The contractor must also overcome the fee-sharing restrictions of § 504. abi

34 *Id.*
35 *Id.*
36 *Id.*, Docket No. 1623 (Bankr. S.D.N.Y. Jan. 28, 2013), and Docket No. 1631 (Bankr. S.D.N.Y. Jan. 28, 2013).
37 *Id.*
38 *Id.*, Docket No. 1743 (Bankr. S.D.N.Y. May 10, 2013).

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