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ETHICS: DISCLOSURE AND DISINTERESTEDNESS; CARVE-OUTS; DISGORGEMENT OF PROFESSIONAL FEES; RULES OF PROFESSIONAL CONDUCT

SUPPLEMENTARY MATERIALS

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1. *In re Baron's Stores, Inc.*, 2007 WL 1120296 (Bankr. S.D. Fla., April 12, 2007)

The debtor, i.e., Baron's Stores, Inc. ("Baron's") filed a Chapter 11 petition and retained Sonya Salkin, Esq. ("Salkin") as its counsel. Prior to the debtor's bankruptcy filing, Ronald C. Kopplow, Esq., Kopplow & Flynn, P.A. ("Kopplow"), and Marc Cooper, Esq., Cooper & Wolfe, P.A. ("Cooper"), served as counsel for the debtor in a state court lawsuit seeking to recover damages for professional malpractice against its former accounting firm. *Id.* at *1. After filing for bankruptcy relief, the debtor retained Kopplow and Cooper as its special counsel, on a contingent fee basis, to continue the malpractice case. Post-confirmation of Baron's bankruptcy case, and three months prior to entry of the Final Decree closing debtor's case, the Lansons, who were officers of the debtor and its sole shareholders, and Baron's (collectively the "Claimants"), (filed a legal malpractice action against Kopplow, Cooper and, later, Salkin in Florida state court, in which they contended that Salkin, Kopplow and Cooper (collectively the "Attorneys") had perpetrated a fraud on the bankruptcy court with respect to their applications to be retained as general and special counsel, respectively. *Id.* More particularly, the Claimants argued that the Attorneys perpetrated a fraud by failing to disclose their connections with interested parties and their conflicts of interest adverse to the debtor, and that their failure to do so vitiated the bankruptcy court's final orders. *Id.* at *7. The state court advised the Lansons that allegations of fraud upon the bankruptcy court should be resolved by the bankruptcy court. The Lanson's and Baron's therefore moved before the bankruptcy court for an order reopening the debtor's case to adjudicate their claims against the Attorneys.

Fraud on the court is narrowly construed and must be proved by clear and convincing evidence. *Id.* at *8. "Generally speaking, only the most egregious misconduct, such as bribery of a judge or members of a jury, or the fabrication of evidence by a party in which an attorney is

implicated, will constitute fraud on the court." *Id.* Analysis of whether a fraud was perpetrated on the court often turns on the existence of intent. In other words, it "is an intentional deflecting of the Court from knowing all the facts necessary to make an appropriate judicial decision on the matter before it." *Id.* Therefore, the Attorneys must have intentionally omitted information from their retention affidavits and motions to have perpetuated a fraud on the court, and not merely have mistakenly left out information. *Id.*

According to the Claimants, the Attorneys were not disinterested as required by 11 U.S.C. § 327(a), failed to disclose interests adverse to the debtor when they had represented a holder of a competing claim against the debtor, and failed to disclose their pre-petition relationships with various creditors and parties of interest. *Id.* at *9. As noted by the decision, Bankruptcy Code Section 327(a) requires professionals to be disinterested, and § 327(e) requires that attorneys hired as special counsel cannot hold any interest adverse to the debtor or the estate with respect to the matter on which the special counsel is employed. *Id.* In finding that the record did not show by clear and convincing evidence that the Attorneys perpetrated a fraud on the court, the Court further noted that Cooper and Kopplow were not bankruptcy attorneys and did not understand the significance of the differences between §§ 327(a) and 327(e), or of disclosing in their affidavits that they were disinterested parties. *Id.* Moreover, the Court found that Cooper and Kopplow did not believe that they held any conflict of interest that would prevent them from representing the debtor in the malpractice case. *Id.* The Court also found that the Attorneys did not intend to defraud the court, but rather that any incorrect references to the wrong Code section or incorrect use of the term 'disinterested' was the result of careless proofreading. *Id.* at *10. The Court determined further that Cooper and Kopplow believed in good faith that none of the parties they represented in the malpractice claim had an interest

adverse to the debtor or the estate. *Id.* at *12. Finally, the Court held that the Attorneys' failure to disclose pre-petition relationships with creditors and interested parties did not evidence a fraud on the court as the Attorneys did not understand that they were required to disclose those attenuated relationships, many of which were unrelated to the present matter. *Id.* at *13.

2. *In re Bay Voltex Corp.*, 2006 Bankr. LEXIS 3702 (Bankr. N.D. Cal., Dec 29, 2006)

In this Chapter 11 case, counsel for the debtor applied for a final allowance of fees totaling $75,672.50 and expenses totaling $916.05. Although debtor was originally a debtor in possession, a Chapter 11 trustee was subsequently appointed. The Chapter 11 trustee objected to fees on two grounds. First, the trustee argued that the fees were not permitted under *Lamie v. US Trustee*, 540 U.S. 526 (2004), which held that § 330(a)(1) of the Bankruptcy Code does not allow compensation to a debtor's attorney out of the estate unless the attorney is employed as authorized by § 327. *In re Bay Voltex Corp.*, 2006 Bankr. LEXIS 3702 at *2. Second, the trustee contended that many of the services provided by the debtor's attorney were not compensable because the services did not benefit the estate and were not reasonably likely to benefit the estate. *Id.*

The court followed *Lamie* and held that the attorney's services rendered after the date of appointment of the Chapter 11 trustee were not payable out of the estate. *Id.* at *3. Even though *Lamie* involved services by a Chapter 7 debtor's attorney, the court found the distinction irrelevant because neither a Chapter 7 debtor nor a Chapter 11 debtor out-of-possession is a trustee and neither represents the estate. Thus, the services performed by the debtor's counsel after the date of appointment of the Chapter 11 trustee, which totaled $33,613.50, were not compensable out of the estate. *Id.*

The court did approve the attorney's compensation for services rendered prior to the appointment of the Chapter 11 trustee, including services rendered negotiating with tax authorities which benefited the estate. *Id.* at *5. However, it determined that, because the debtor's application to employ the attorney and the fee agreement between those parties indicated that they intended for the retainer to serve as security for any allowed fees in the case, debtor's counsel had to apply his pre-petition retainer to his allowed fees and costs, rather than against the fees that the court had disallowed. *Id.* Thus, debtor's counsel was to be compensated for services and expenses rendered prior to the Chapter 11 trustee's appointment out of the retainer without the need to share same, but was only entitled to payment from the estate for a prorated share of the balance of the allowed amount remaining after application of the retainer.

3. *Costa v. Robotic Vision Sys. (In re Robotic Vision Sys.)*, 2007 Bankr. LEXIS 828 (B.A.P. 1st Cir., March 21, 2007)

Robotic Vision Systems, Inc. and Auto Image ID, Inc. (the "Debtors") filed for protection under Chapter 11 of the Code. The cases were jointly administered. The Debtors sought authority pursuant to § 363(c) to use cash collateral encumbered the liens of three parties, including Costa. *Costa v. Robotic Vision Sys. (In re Robotic Vision Sys.)*, 2007 Bankr. LEXIS 828 at *3. The parties subsequently reached an agreement concerning the use of cash collateral, to which Costa expressly consented. *Id.* The cash collateral order was set up to include a carve-out for the purpose of paying "professional fees essential to administering the estate." (the "Carve-Out") *Id.* at *12. The Carve-Out agreement stated that "[a]ll pre-petition retainers and any other unencumbered property of the estate shall be used to pay any allowed fees and expenses of the Professionals before any payment of such fees or expenses are made from the Carve-Out. . . [but] nothing herein shall be construed as consent to the allowance of any fees or

expenses of the Professionals or shall affect the rights of the Lender to object to such amount." *Id.* at *3-4. When the case was converted to Chapter 7, the conversion order expressly directed the preservation of the Carve-Out fund for the Chapter 11 professionals. *Id.* at *5.

The various Chapter 11 professionals, including debtor's counsel, filed final fee applications for payment of their fees from the Carve-Out fund; if the fund was insufficient to cover all of their fees, they requested allowance, and payment, as Chapter 11 administrative expenses. *Id.* Costa, however, filed objections to several of the fee applications, including that of debtor's counsel, and objected to the disproportionate payout from the estate to certain professionals. According to Costa, the problem concerning the Carve-Out was that it "removed estate funds from the Code's priority scheme and dedicated those funds exclusively for the benefit of designated professionals." *Id.* at *17 n.25. Thus, in cases of administrative insolvency such as this one, the designated professionals would receive a larger portion of their administrative claims than would other claimants. *Id.*

The Bankruptcy Appellate Panel noted that disgorgement is often used as a remedy in order to ensure that administrative claimants receive similar shares of their administrative claims. However, the court's holding did not directly address this issue. Instead, the court --after providing a most helpful explication concerning carve-outs, described as "the warp and woof of reorganization practice"-- granted the debtor's counsel authority to use the Carve-Out fund and overruled Costa's objection. Among other reasons, the B.A.P.'s holding turned on the fact that Costa had expressly consented to the Carve-Out fund and failed to object or appeal either the order establishing the fund or any subsequent order amending the fund agreement.

4. *In re Cygnus Oil & Gas Corp.*, 2007 WL 1580111 (Bankr. S.D. Tex., May 29, 2007)

The debtor corporation filed for Chapter 11 and then filed an expedited application to approve the retention of its counsel. The United States Trustee, however, contested the application, arguing that the counsel was not a "disinterested person", and thus was not able to represent the debtor.

The U.S. Trustee based his objection on three factors. First, an attorney at the firm held 100,000 shares of stock in the debtor corporation. Second, the attorney had served as a director of the debtor corporation for a period of approximately five months pre-petition. Third, the attorney's firm held an unpaid pre-petition claim of over $77,000 against the debtor corporation.

In addressing these objections, the court noted that Sections 101(14) and 327 of the Bankruptcy Code govern a debtor's ability to retain counsel. Section 327(a) states that "'the trustee, with the court's approval, may employ one or more attorneys . . . that do not hold or represent an interest adverse to the estate, and that are disinterested persons . . .'" The Bankruptcy Code defines a "disinterested person" as a person who is "(A) 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 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." 11 U.S.C. § 101(14).

The thrust of the U.S. Trustee's argument was that the attorney's involvement with the debtor corporation should have been imputed to the law firm, thereby disqualifying the entire firm. The issue of whether the actions of one member of a law firm may be imputed to the entire firm is one of statutory interpretation. The Delaware Bankruptcy Court, in *In re Essential*

Therapeutics, Inc., 295 B.R. 203 (Bankr. D. Del. 2003), had previously confronted the issue and found that "[b]ecause a law firm can only act through the association of individuals who make up the firm, the Court found that 'the disqualification of one must be attributed to all.'" *Id.* at 210 (quoting *In re Michigan Interstate Ry. Co.*, 32 B.R. 327, 330 (Bankr. Mich. 1983)). However, the *Cygnus* court noted that this *per se* rule of disqualification has not been adopted or applied in the majority of circuits addressing this issue. In fact, it stated that courts in the Ninth Circuit have rejected a reading of § 101(14) requiring a *per se* imputation of a single member's lack of disinterestedness to the member's firm. Other circuits have followed the Ninth Circuit's lead, similarly finding that while other sections of the Bankruptcy Code do result in vicarious disqualification, there is no express language in the Bankruptcy Code requiring a firm to be disqualified on the basis of one non-disinterested member. *Id.* at 4.

The *Cygnus* court thus followed the majority and held that the Bankruptcy Code is unambiguous. Noting that Section 101(14), by its plain language, specifically applies to any "person", the court stated that it was one litigation partner who was the equity holder and director, not the firm. "Had Congress intended to impute a single member's disqualification to her entire firm, it would have done so." *Id.* at 5 (quoting *In re Timber Creek, Inc.*, 187 B.R. 240, 243 (Bankr. W.D. Tenn. 1995)). Therefore, the firm was not disqualified from representing the debtor corporation.

The analysis in this case turned on whether the firm met the criteria of a "disinterested person" under § 101(14). The court found that an indirect relationship existed between the debtor corporation and the firm through the attorney's interest in the debtor corporation. The standard that it applied was whether the firm, by an indirect interest, had an interest materially adverse to the debtor corporation. *Id.* at 7. The court did not find any evidence that the firm had

a direct or indirect interest materially adverse to the debtor corporation and, therefore, the firm was a disinterested person under § 101(14). *Id.* Moreover, by waiving its right to payment upon its pre-petition claim against the debtor, the firm was also no longer a creditor as defined by § 101(10). As a result, the firm could serve as counsel. *Id.*

5. *In re J.S. II, LLC*, 2007 WL 1593204 (Bankr. N.D. Ill., May 30, 2007)

J.S. II, LLC, a real estate developer, was a manager-managed limited liability company whose members were Kinsella, Diamond and Snitzer. A second debtor, River Village I, was formed to serve as the development agent and was also a manager-managed limited liability company, with Kinsella L.P, Diamond L.L.C, and the Snitzer Family LLC (the "Snitzer Parties") as members. *Id.* After filing for Chapter 11, the debtors filed an application for authority to employ Tabet Divito & Rothstein ("Tabet D&R" or "TDR") as Special Litigation Counsel to represent the debtors in litigation pending in state court.

The plaintiffs and the counter-defendants in the state court litigation (*i.e.*, the Snitzer Parties) objected to the debtors' application to retain Tabet D&R to pursue and to defend the state court litigation, claiming that the law firm had represented Kinsella and Diamond individually, and not the debtors, in that proceeding, and thus their interests were adverse to the debtors. *Id.* at *5. The Snitzer Parties also claimed that the appointment of Tabet D&R was not in the best interest of the estate. *Id.*

Addressing the Snitzer Parties' objection, the court first noted that Section 327 of the Bankruptcy Code governs the employment of professionals. *Id.* at *4. Section 327(a) provides that a professional who does not hold or represent an interest adverse to the estate and who is a disinterested person may be employed by the trustee or debtor in possession. *Id.* However, an exception exists under § 327(e), which provides that, with court approval, a trustee or debtor in

possession may employ a professional, for a specified special purpose, other than representing the trustee in the case, if in the best interest of the estate, and if such professional does not have an interest adverse to the estate or the debtor with respect to the matter on which such professional will be employed. *Id.* While there is no requirement under § 327(e) that the attorney be disinterested, there is a strict requirement that the appointed special counsel should not have a personal interest that might affect his decision or impair the expected impartiality of the attorney. *Id.* Furthermore, the majority of courts impose an additional requirement on § 327(e) that the attorney seeking employment as special counsel must have represented the debtor at some point prior to the commencement of the bankruptcy case. *Id.* at *5. However, there is no requirement that the previous representation must have been for the same matter or litigation at issue. *Id.*

Tabet D&R was found to have satisfied all of the elements of § 327(e). The fact that the law firm had previously represented the Debtors as well as two members of the debtor's real estate LLC satisfied the "prior representation" element. *Id.* at *6. Furthermore, the court found that the representation was in the best interest of the estate. The "benefit is 'gauged by needs of the estate and whether it is directly related to the debtor in possession's performance of duties under the bankruptcy code'." *Id.* Noting that if was more than likely that the pace of the litigation would slow down the debtors were forced to hire new counsel, the court further opined that hiring new counsel would add increased expenses to bring them up to speed rather than if Tabet D&R was permitted to pick up where it ended in state court when the bankruptcy case was filed. *Id.* at *7. Finally, Tabet D&R did not hold an interest adverse to the interests of the debtors. "The purpose of the no 'adverse interest' requirement is to ensure that special counsel is able to objectively advise the client which in this interest is the debtor in possession. [Citation omitted.)]…[T]he critical element in making this determination is whether an 'adverse interest'

exists. [(Citation omitted.)]." *Id.* The "adverse interest" must be an actual or reasonably probable conflict of interest.

In this case, the debtors only sought to employ TDR for the purpose of prosecuting the debtors' claims against Snitzer and not to defend the claims against the two members. *Id.* at 8. Moreover, TDR acceded to certain suggestions of the United States Trustee concerning allocation of their fees between and among the Debtors and the other parties it represented in the state court litigation and billing related thereto. This, and various other protections led the court to state:

> This is a no-lose situation for the Debtors. Each side is suing derivatively on the Debtors' behalf. If the Kinsella and Diamond parties prevail, the Debtors will recover on those parties' derivative claims. If the Snitzer Parties prevail, the debtors will recover on those parties' derivative claims. Regardless of who prevails in the state court action, the debtors will recover.

Therefore, retention of Tabet D&R pursuant to § 327(e) was permitted.

6. *In re M.T.G., Inc.*, 366 B.R. 730, 2007 WL 1119672 (Bankr. E.D. Mich., April 16, 2007)

Debtor filed for relief under Chapter 11, but its case was ultimately converted to Chapter 7 and a Chapter 7 trustee was appointed. The trustee thereafter filed a statement attesting that his law firm was disinterested and could serve as counsel for the trustee. *Id.* at *2. Under the Local Rules for the Eastern District of Michigan, the filing of this statement meant that the trustee and his law firm were appointed as counsel without the entry of an order. *Id.*

The debtor's primary lender, Comerica, claimed a security interest in all of debtor's assets. In the face of this asserted blanket lien, the trustee entered into a fee agreement with Comerica which provided that (i) the trustee would liquidate the debtor's estate assets with certain exceptions, (ii) the trustee was to bill Comerica for legal services each month, and (iii) all

net proceeds of the liquidation of the assets would be paid to Comerica. *Id.* at *2. However, the trustee did not disclose his fee agreement with Comerica at any point, including during proceedings surrounding a subsequently obtained stay-relief order, a later settlement order, and an order allowing Comerica's secured claim. *See id.* at *3-4, *5. Although the trustee referred to a surcharge agreement with Comerica, at various times, he never disclosed any details regarding his separate fee agreement with Comerica. *Id.* at *5. Even when the trustee later joined a new law firm, he again failed to disclose his fee agreement with Comerica in his Rule 2014 disclosure statement. *Id.* at *6.

The trustee thereafter continued to investigate certain lender liability claims that the debtor had asserted against Comerica. Yet, throughout the entire proceeding, the trustee failed to disclose his separate fee agreement with Comerica.

Debtor's attorney subsequently moved to set aside the court's Comerica settlement order based upon a claimed conflict of interest due to the fee agreement between the trustee and Comerica. *Id.* at *8. The debtor's attorney claimed that this conflict of interest should have been disclosed as part of the trustee's appointment process and in conjunction with the trustee's motion for authority to settle the estate's lender liability claims against Comerica. *Id.*

Ultimately, the debtor's attorney moved to set aside the settlement order, the Comerica claim allowance order, and the Comerica relief from stay order on the basis that the trustee and Comerica had perpetrated a fraud upon the court. *Id.* at *12. The elements of fraud on the court are conduct (1) on the part of an officer of the court; (2) [t]hat is directed to the 'judicial machinery' itself; (3) [t]hat is intentionally false, willfully blind to the truth, or is in reckless disregard for the truth; (4) [t]at is a positive averment or is concealment when one is under a duty to disclose; (5) [t]hat deceives the court." *Id.* at *15. Based upon the facts and the record, the

court held that the parties had perpetrated a fraud upon the court in connection with each of the three orders previously obtained by the trustee. *Id.* Each order had benefited Comerica and was entered by the court at the trustee's request at a time when he had an egregious conflict of interest. *Id.*

The court specifically found that, with respect to the trustee, all of the elements of fraud on the court were satisfied. The trustee was an officer of the court and his failure to disclose his fee agreement with Comerica -- which he had a duty to disclose -- was directed to the 'judicial machinery' itself, rather than a private party. *Id.* at *16. Furthermore, the trustee had acted intentionally and with reckless disregard for the truth when he clearly made false representations that he was a disinterested party without any connection to any party in interest. Clearly, the trustee had an affirmative duty under Bankruptcy Rule 2014 and Bankruptcy Code § 327 to disclose the Comerica fee agreement and its terms. *Id.* at *17. Additionally, when the trustee and his attorneys did not disclose the fee agreement with Comerica when they had a clear duty to do so, the trustee was found to have concealed the fee agreement from the court. *Id.* at *18. As a result of these defalcations, the court concluded that the trustee had deceived the court and vacated all three orders, *i.e.*, those allowing Comerica's secured claim, granting Comerica relief from the stay, and authorizing the trustee's settlement of various courses of action against Comerica. The court denied without prejudice, however, and thus left for another day, a ruling upon requests for punitive damages and attorneys' fees. *Id.*

7. *Olson v. Bays (In re Seek Wilderness, Ltd.)*, 2007 Bankr. LEXIS 1734 (Bankr. W.D. Mich., May 15, 2007)

The Chapter 7 trustee filed an adversary complaint seeking to compel the debtor's attorney to disgorge a $7,500.00 retainer paid in connection with his pre-petition representation

of the debtor and post-petition representation of the Chapter 11 bankruptcy estate. The trustee based her claims upon the Sixth Circuit's determination that 11 U.S.C. § 726(b) requires Chapter 11 professionals to disgorge fees in the event that there remain unpaid Chapter 11 administrative claimants at the close of a Chapter 7 case. *Specker Motor Sales v. Eisen, 393 F.3d 659 (6th Cir. 2004)*.

The debtor's attorney had sought payment by the estate of only $1,700.27 (the difference between the amount of fees and expenses and the retainer) as a Chapter 11 administrative expense pursuant to § 503(b)(1). *Id.* at *4. The trustee did not dispute the reasonableness of the attorney's fees but contested his request to receive reimbursement from the estate, and also claimed that the attorney must disgorge a portion of those fees that he had previously deducted from his pre-petition retainer in order to equalize the attorney's distribution as a Chapter 11 administrative claimant with other claimants. *Id.* at *5.

The court characterized the bankruptcy estate's interest in the pre-petition retainer paid by the debtor to his attorney as a "security interest" or "deposit" to secure payment of the attorney's fees that had already been incurred and to secure payment for the attorney's future services. *Id.* at *7. The court found that *Specker* was inapplicable because the amount due for pre-petition services was not an administrative claim, *Id.* at *10, but also noted that an attorney who represents a Chapter 11 debtor pre-petition does not have priority to any pre-petition fees that remain unpaid at the commencement of the Chapter 11 case. However, the existence of the attorney's pre-petition retainer for services rendered prior to the commencement of the Chapter 11 proceeding turned his claim for those services from that of an unsecured creditor to one of a secured creditor. *Id.* Thus, the attorney was entitled to recover the full amount of his pre-

petition fees from the retainer before any distribution could be made to unsecured creditors of the bankruptcy estate, priority or otherwise.

The court next opined that the question of whether the remaining balance of the pre-petition retainer could be applied against services rendered post-petition, or whether the attorney was required to disgorge some, or all, of the remaining retainer, was not as clear. The debtor's application to employ the attorney as the Chapter 11 estate's attorney indicated that the estate intended the $2,700.00 retainer balance to secure fees due to the attorney for his post-petition services. *Id.* at *15. However, ownership of the $2,700.00 that remained at the commencement of the bankruptcy case transferred the estate by operation of § 541(a)(1). *Id.* at *14. As a result, the court stated that "the change in ownership did preclude…[debtor's counsel] from looking to the remaining $2,700 of the retainer for payment of any post-petition services…[he] might have rendered on behalf of Seek Wilderness in its previous capacity as opposed to in its capacity as debtor-in-possession of the bankruptcy estate…." *Id.* Thus, it did not automatically secure counsel's post-petition services.

As noted above, the debtor-in-possession's application to retain counsel indicated an intention to secure post-petition fees with the balance of the retainer. However, the Order authorizing counsel's employment failed to mention the retainer.

> The question, then, is whether Section 327(a), which is the Bankruptcy Code section that mandates court approval of the estate's employment of a professional, includes within its ambit the approval of retainers reached as part of that agreement. In other words, must the Court actually approve a retainer agreement as part of the Section 327(a) employment process before the retainer agreement can become enforceable against the bankruptcy estate? Moreover, creation of a retainer constitutes a use of the bankruptcy estate's property. Consequently, the $2,700 retainer that remained as of the commencement of the bankruptcy case could not have simply "become" a new retainer to secure… [counsel's] post-petition services on behalf of the estate. Rather,… [counsel's]

> ability to look to this remaining amount for payment was conditioned upon Seek Wilderness, as debtor-in-possession, having had the authority under the Bankruptcy Code to use the bankruptcy estate's assets in that fashion regardless of whether Section 327(a) approval was required or not. [(Footnote omitted)]

In addressing these issues, the court found that the agreement reached between the debtor's attorney and the estate was an agreement for the attorney to provide services without immediate reimbursement in exchange for the bankruptcy estate's promise to secure the fees at least in part from distributions from the estate. *Id.* at *17. Consequently, it was arguable that the arrangement reached with counsel was a credit transaction within the meaning of Section 364 and thus subject to evaluation under § 364(c)(2).

The court determined that further proceedings were necessary to assess whether the attorney must disgorge all, or some portion of, the retainer remaining at the commencement of the Chapter 11 case. The court thus required counsel to address the issue of whether the estate was properly authorized under §§ 327, 363 and 364 to give the remaining retainer to the attorney for post-petition services, s*ee id.* at *17-20, and ultimately held that, even if the estate had the authority to do so, *Specker Motor* required that the attorney return at least some portion of the post-petition retainer pursuant to § 726(b). *Id.* at *21. The court then addressed the proper "formula" to be used for calculation of the portion of the retainer that the attorney would be required to disgorge, and directed that there be further proceedings related thereto consistent with the court's rulings.

8. *In re SONICblue Incorporated*, 2007 WL 926871 (Bankr. N.D. Cal., March 26, 2007)

In April 2002, SONICblue raised financing in a private placement of senior secured subordinated convertible debentures. *In re SONICblue Inc.*, 2007 WL 926871, *2 (Bankr. N.D. Cal. 2007). As counsel to SONICblue in connection with that private placement, Pillsbury

Winthrop Shaw Pittman LLP ("PWSP") issued a written opinion to senior bondholders as to, among other things, the enforceability of the debentures. *Id.* Approximately six months later, when SONICblue was unable to meet its maturing financial obligations, SONICblue retained PWSP to assist it in restructuring certain of its existing debt; the engagement also included representation in any subsequently commenced bankruptcy case.

On March 21, 2003, SONICblue and its subsidiaries filed for relief under Chapter 11 of the Bankruptcy Code. *Id.* at *3. Three weeks later, PWSP filed its retention application accompanied by a verified statement pursuant to Bankruptcy Rule 2014, which contained disclosures regarding its relationship with the debtors and various creditors. However, the firm failed to disclose its "connection" to the senior bondholders resulting from its issuance of the opinion letter to those bondholders one year earlier. *Id.*

The court granted PWSP's retention application. Shortly after the appointment of PWSP as debtor's counsel, the Office of the United States Trustee appointed an Official Committee of Unsecured Creditors (the "Committee"), which included the senior bondholders among its members. *Id.* at *4.

The senior bondholders subsequently timely filed proofs of claim which included claims for an original issue discount approximating $43 million. When PWSP challenged the senior bondholders' claim, their counsel brought to debtors' counsel's attention the previously issued opinion letter; he asserted that the bondholders had relied on that letter as assurance that their claims would be allowable in a later filed bankruptcy case, and "further indicated that the bondholders would demand that PWSP defend and indemnify them for any losses resulting from SONICblue's challenge to their claim…." *Id.* at *7.

After PWSP received these demands for indemnification from the senior bondholders, PWSP turned over to the Committee the task of prosecuting objections to the senior bondholders' claims. *Id.* at *8. PWSP did not, however, file a supplemental Rule 2014 disclosure to address the senior bondholders' claims. It was not until PWSP filed its eighth interim fee application on October 18, 2006 that it addressed the analysis of, and potential objection, to the senior bondholders' claim and simply stated: "The matter was turned over to the Creditors' Committee for prosecution."

Thereafter, in response to objections to the Joint Plan and Disclosure Statement filed by the Debtors and the Creditors' Committee, an amendment to the Disclosure Statement began to provide a more meaningful description of the senior bondholders' claims and the grounds therefor. However, it was not until more than six months after the senior bondholders first asserted their claims against PWSP, and only after the United States Trustee had filed a motion for the disqualification of PWSP as debtors' counsel, that a meaningful, appropriately descriptive supplemental Rule 2014 disclosure statement that provided a detailed explanation of PWSP's conflict of interest with the senior bondholders was finally filed.

Based upon the information set forth in this eighth supplemental disclosure statement, the Court stated as follows:

> From these facts it is clear that PWSP knew it had a continuing duty to update its Rule 2014 disclosures upon learning of any undisclosed connections or conflicts. It is also apparent that as of late August 2006, PWSP knew it had a disabling conflict of interest because it immediately sought the aid of LNBRB in an attempt to resolve the conflict. Yet, PWSP failed to apprise the court of these facts. PWSP's attempt to characterize its failure as inadvertent oversight rings hollow in the face of its previous history of supplemental disclosures. PWSP argued in court that the partner in charge "assumed" a supplemental disclosure had been made, but the firm has not offered any evidentiary foundation for that assumption. The declaration of PWSP partner William

> Freeman indicates that Freeman had signed several of the earlier supplements and that he typically delegated responsibility for drafting the disclosures. There is no indication, however, that Freeman or any other PWSP partner undertook responsibility, or asked someone else to assume responsibility, for preparing a supplemental disclosure when the actual conflict of interest concerning the senior bondholders arose. PWSP has neither offered proof of any time spent drafting the disclosure nor produced a draft of a disclosure that the firm somehow failed to file. **In the end, however, 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 this case. Estate professionals must make full, candid and complete disclosures of all facts affecting their eligibility for employment.** *In re Plaza Hotel Corp.*, 111 ___ B.R. ___ at 883, *aff'd*, 123 ___ B.R. ___ 466 (9th Cir.B.A.P.1990). *See also Neben & Starrett, Inc. v. Chartwell Financial Corp.* (*In re Park-Helena Corp.*), 63 F.3d 877, 881 (9th Cir.1995), *cert. denied*, 516 U.S. 1049 (1996)(affirming denial of all fees after debtor's counsel failed to fully disclose circumstances surrounding payment of firm's retainer). **The Rule 2014 disclosure requirements are strictly enforced.** *Park-Helena*, 63 F.3d at 881-82. **Negligent omissions do not excuse failures to disclose.** *Plaza Hotel*, 111 ___ B.R. ___ at 883. Although PWSP has offered its future service in some more limited capacity, it would not be helpful because the firm's motive this case would remain subject to attack.
>
> The entirety of the undisputed facts also provides clear and convincing evidence that the appointment of a chapter 11 trustee is necessary to restore creditor confidence in the bankruptcy system and to assure that there is no lingering taint from PWSP's representation of the debtor. Neither the court nor the creditors may ever learn why PWSP or Smith, as debtor's responsible individual, failed to bring PWSP's conflict to the court's attention. But, that unanswered question is less important with the appointment of a strong, neutral trustee, who has no connections to any interested party. [*Id.* at *12 (emphasis supplied).]

In addition to the significant issues related to the undisclosed conflicts of debtors' counsel, the court also addressed possible conflicts regarding counsel for the Creditors' Committee and their failure (as alleged by claims traders) to "fulfill its role as a watchdog on behalf of the unsecured creditors…," stating:

> It is not clear at this juncture whether LNBRB's handling of the objections of the bondholders was an actual conflict of interest, however, it is worth noting that under § 328(c), unless adequate disclosure is made and prior approval of the court is obtained, committee counsel can be denied compensation if at any time during the representation counsel is not a disinterested person. *Mesta Machine,* 67 ___ B.R. ___ at 157-158. No disclosures were made and no court approval was obtained with respect to LNBRB's acceptance of the claims objections referred from PWSP. Finally, SB Claims suggests, and the record does not dispel, the belief that LNBRB's conduct was a self-interested act to protect its referral sources. A committee controlled by the three senior bondholders hired LNBRB and, of course, has the continuing ability to fire LNBRB. If not an actual conflict, these facts certainly raise questions regarding LNBRB's suitability to vigorously pursue the claims objections on behalf of the estate. Moreover, the protective atmosphere surrounding this close-knit referral circle is reminiscent of the "opprobrious" bankruptcy ring and the cronyism that Congress decried in the legislative history of the Bankruptcy Reform Act of 1978. H. Rep. No. 95-595, at 6011 (Sept. 8, 1977).
>
> The fact that counsel for claims traders flagged the concerns over potential improprieties or that the claims traders' may be acting in their own self-interest does not detract from the troublesome nature of their arguments. Nevertheless, these very significant concerns are outweighed in this case by the need for the appointment of a strong and disinterested trustee. [*Id.* at *14-*15.]

After carefully reviewing all of the evidence, the court concluded that the United States Trustee had proved adequate grounds for the disqualification of PWSP and the appointment of a Chapter 11 trustee. However, the court reserved for a later hearing the issue of PWSP's disgorgement of fees.

9. *In re Rockaway Bedding, Inc.*, 2007 WL 1461319 (Bankr. D.N.J., May 14, 2007)

In this Chapter 11 case, the Debtor applied to retain bankruptcy counsel pursuant to 11 U.S.C. §327(a). The United States Trustee objected to the application based upon proposed counsel's previous and ongoing representation of certain of the Debtor's pre-petition creditors,

including the bank that was Debtor's largest secured creditor and with whom proposed counsel had already negotiated two cash collateral orders on behalf of the Debtor. *Id.* at *1.[1]

In addressing the US Trustee's objection, the Court noted that given these facts and that (i) proposed counsel generated fee revenue from the bank, (ii) a member of the firm's creditors rights and insolvency group, maintained, and that many of the firm's over 1300 other employees might maintain, a personal account at the bank, and (iii) the spouse of a member of the firm recently retired from her position with an entity affiliated with the bank, "potential" conflicts existed. *Id.* However, the Court also noted that proposed counsel had sought to resolve any possible conflicts in connection with its proposed retention.

First, the bank had executed a conflicts waiver, which (x) Debtor had consented to, (y) provided that professionals providing bankruptcy services to the Debtor were not permitted to work concurrently on unrelated bank matters, and (z) provided that proposed counsel agreed not to assert any claim of fraud, misrepresentation or dishonest conduct against the bank in connection with the Debtor's Chapter 11 case (and if such a situation would arise, separate counsel would be retained to pursue such matters or the Official Committee of Unsecured Creditors would be allowed to assert such claims). *Id.* at *2. Second, proposed counsel represented to the Court that any ongoing matters on behalf of the bank would be handled by professionals in the firm's other offices and that a "wall" on its firm-wide computer system would insure against possible disclosure of privileged or confidential information. *Id.* Finally, the Court noted that, in support of the firm's retention, proposed counsel submitted affidavits, including an affidavit from outside general counsel to the Debtor, which stated that proposed

[1] No allegation was leveled against proposed counsel that it had failed to make disclosures required for the employment of a professional pursuant to Fed.R.Bankr.P. 2014.

counsel had already zealously represented the Debtor and the introduction of replacement bankruptcy counsel would irreparably harm the Debtor's reorganization efforts. *Id.*

In determining whether proposed counsel could be retained, the Court looked to 11 U.S.C. § 327(c), which it stated makes clear that proposed counsel cannot be disqualified solely because of the representation of a creditor unless an objection is raised by the U.S. Trustee and an "actual conflict" is found to exist. *Id.* In this regard, the Court stated that the holding of *In re Marvel Entm't Group, Inc.*, 140 F.3d 463 (3d Cir. 1998) was controlling. That case held that although 11 U.S.C. §§ 327(a), (c) impose a *per se* disqualification of any attorney with an actual conflict of interest, the court may not disqualify an attorney on the appearance of a conflict, alone. *Id.* The Court also noted that the court in *Marvel* recognized an exception to disqualification in light of a potential conflict where the possibility that the potential conflict will become actual is remote, and the reasons for employing the professional in question are particularly compelling. *Id.*

Based upon the analytical framework of *Marvel,* the Court looked at the facts and circumstances before it and first determined that no actual conflict existed between the Debtor and the bank, inasmuch as there was no active or envisioned litigation between the parties, the bank had executed a conflicts waiver, and no evidence was presented to the Court that an actual conflict of interest existed. *Id.* at *3-*4. Therefore, the Court stated that the issue then became whether, under the particular facts and circumstances of the case, the potential for a conflict of interest is remote and there exist reasons for retaining proposed counsel. *Id.* at *4. In this regard, the Court noted that: (i) there was no ongoing or envisioned litigation among the bank and the Debtor; (ii) proposed counsel had already aggressively negotiated with the bank in protecting the Debtor's rights; (iii) proposed counsel had instituted an electronic ethical wall; (iv)

all the work to be done for the Debtor would be done in a separate office from that where work was done for the bank; (v) professionals working on unrelated matters for the bank were precluded from handling the bankruptcy proceeding; (vi) matters relating to fraud were carved out of the waiver; (vii) proposed counsel had acted with diligence since the inception of the bankruptcy case in disclosing any known potential conflicts; (viii) no other potential conflicts had been presented to the Court; (ix) as evidenced from the affidavits of Debtor's own outside general counsel and financial consultants, proposed counsel's representation of the Debtor had been professional and effective and there would be irreparable harm with respect to the Debtor's reorganization efforts if it was required to find replacement counsel; (x) the Official Committee of Unsecured Creditors had consented to proposed counsel's retention; (xi) based upon a recently granted motion by the Court authorizing Debtor's sale of inventory and leases, it was evident that the Debtor was in a fragile economic state and that a disruption in its downsizing could result in the implosion of its attempt to reorganize; and (xii) proposed counsel has negotiated the outcome of several motions and had already become intimately familiar with the Debtor's operations and business.[2] *Id.* Based upon all of these factors, the Court held that proposed counsel could be retained because there was no more than a remote potential conflict and compelling reasons existed to authorize its representation.[3] *Id.* at *5.

[2] The Court noted that proposed counsel received pre-petition payments as a retainer for its prospective services, but such payments could not be avoided as preferential transfers because they were not made on account of an antecedent debt. As such, proposed counsel's representation is not barred by the existence of an avoidable transfer.

[3] The Court noted that proposed counsel's representation was in accordance with New Jersey Rule of Professional Conduct 1.7, which deals with conflicts of interest.

10. <u>Other decisions of interest regarding "disgorgement":</u>

(A) ***Bernheim v. Damon and Morey, LLP,*** **2007 WL 1858292 (2d Cir., June 28, 2007)** (bankruptcy judge had found that the DIP's law firm labored temporarily under a conflict, but nevertheless ordered no disgorgement; the Court of Appeals held that disgorgement was not required, as a bankruptcy judge's decision whether to order disgorgement based on a conflict of interest is discretionary)**;**

(B) ***In re Count Liberty,*** **___ B.R. ___, 2007 WL 1705627 (Bankr. C.D. Cal., May 4, 2007);**

(C) ***In re Davis,*** **2007 WL 1219718 (Bankr. N.D. Al., April 25, 2007);** and

(D) ***In re Perrine,*** **___ B.R. ___, 2007 WL 1186600 (Bankr. C.D. Cal., April 13, 2007).**