New Jersey Law Journal

VOL. CLXXIX – NO. 12 – INDEX 1174 MARCH 21, 2005 ESTABLISHED 1878

BANKRUPTCY LAW

Retention Issues in Bankruptcy

The hiring of professionals in a bankruptcy case raises a unique set of concerns

By Henry M. Karwowski

In bankruptcy cases, the hiring of professionals, such as lawyers and accountants, implicates a number of issues. Common retention issues in bankruptcy include: approval of retention; the definitions of the terms "hold or represent an interest adverse to the estate" and "disinterested person"; the general standard governing retention; exceptions to the governing standard; the application of the Rules of Professional Conduct; the need for disclosure; and disallowance of compensation resulting from failure to comply with the applicable retention standards.

Approval of Retention

Under section 327(a), a trustee or debtor-in-possession may, only with the court's approval and except as otherwise provided below, employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons (i) that do not hold or represent an interest adverse to the estate and (ii) that are disinterested persons, to represent or assist the trustee. 11 U.S.C. §327(a). This statute requires approval of retention even if compensation is derived from a source other than the estate. *Ferrara & Hantman v. Alvarez* (*In re Engel*), 124 F.3d 567, 571 (3d Cir. 1997).

Notwithstanding this requirement, bankruptcy courts may, in extraordinary circumstances, grant retroactive approval of professional employment. *F/S Airlease II, Inc. v. Simon* (*In re F/S Airlease II, Inc.*), 844 F.2d 99, 105 (3d Cir.) (citing *In re Arkansas Co.*, 798 F.2d 645, 646 (3d Cir. 1986)), cert. denied, 488 U.S. 852 (1988). In determining the propriety of such approval, bankruptcy courts apply the following test: (1) the bankruptcy court must find, after a hearing, that the applicant satisfies the adverse interest and disinterestedness requirements of section 327(a), and hence, that it would have granted prior approval; (2) the court must find that the services performed were necessary under the circumstances; and (3) the court must, in the exercise of its discretion, consider whether the particular circumstances adequately excuse the failure to seek prior approval. Id. (citing *Arkansas*, 798 F.2d at 650). Such circumstances do not include the mere neglect of the professional. *Arkansas*, 798 F.2d at 650. In fact, according to the Third U.S. Circuit Court of Appeals, approval should be limited to cases in which the hardship is not of the professional's own making. Id.

The Third Circuit has directed that bankruptcy courts, in exercising their discretion regarding the existence of "extraordinary circumstances," consider factors such as:

> whether the applicant or some other person bore responsibility for applying for approval; whether the applicant was under time pressure to begin service without approval; the amount of delay after the applicant learned that initial approval had not been granted; the extent to which compensation to the applicant will prejudice innocent third parties; and other relevant factors. F/S, 844 F.2d at 105-06 (quoting *Arkansas*, 798 F.2d at 650).

In only a single published decision has a New Jersey court granted such approval. *In re Freehold Music Ctr., Inc.*, 49 B.R. 293, 294-96 (Bankr. D.N.J. 1985) (authorizing accountants' employment nunc pro tunc where accountants performed work essential to the continuation of debtors' business and believed that authorization for their work had been obtained or properly arranged).

Karwowski is a partner at Booker, Rabinowitz, Trenk, Lubetkin, Tully, DiPasquale & Webster of West Orange and an adjunct professor at Seton Hall University School of Law.

Meanwhile, in the majority of published decisions regarding this issue, courts in this circuit have declined to grant nunc pro tunc approval. See, e.g., *F/S*, 844 F.2d at 106-08 (holding that extraordinary circumstances justifying nunc pro tunc approval of broker's employment were absent on grounds that, Rule 2014(a), requiring that the debtor actually file the professional's application, did not relieve broker of responsibility to insure that retention approval had been sought, broker was sophisticated businessman, and broker did not seek approval until almost a year after he had commenced services).

Governing Standard

The Third Circuit has implemented the following standard to govern adverse interests: (i) section 327(a) imposes a per se disqualification as the trustee's or debtor-in-possession's counsel of any attorney who has an actual conflict of interest; (ii) the bankruptcy court has wide discretion in determining whether to disqualify an attorney who has a potential conflict of interest; and (iii) the bankruptcy court may not disqualify an attorney on the appearance of conflict alone. *In re Marvel Entm't Group. Inc*., 140 F.3d 463, 476 (3d Cir. 1998) (citing *In re BH & P Inc*., 949 F.2d 1300 (3d Cir. 1991)).

A conflict is actual, and hence per se disqualifying, if it is likely that the professional will be placed in a position permitting it to favor one interest over a conflicting interest. *In re Pillowtex, Inc*., 304 F.3d 246, 251 (3d Cir. 2002) (citing *BH & P*, 140 F.3d at 1315). In addressing potential conflicts, the Third Circuit has noted that a court should generally decline approval of employment of a professional with a potential conflict, with certain possible exceptions. *BH & P*, 949 F.2d at 1316. First, "there may occasionally be large cases where every competent professional in a particular field is already employed by a creditor or a party in interest." Id. "The other exception is 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.

Courts in this district and circuit have applied this standard in a number of contexts. For instance, in *BH & P*, the Third Circuit held that the bankruptcy court had not abused its discretion in finding that counsel's representation of the Chapter 7 trustee in joint proceedings of a corporation and its principals asserting interdebtor claims created an actual conflict warranting disqualification. Id. at 1315. Likewise, in *Star*, 81 B.R. at 840-41, involving the substantively consolidated cases of a debtor corporation and its debtor sole owner, herself a creditor of the debtor corporation, the bankruptcy court held that an actual conflict existed in a law firm's dual representation of the corporation and the sole owner.

Meanwhile, in *In re Brennan*, 187 B.R. 135, 146, 148-49 (Bankr. D.N.J. 1995), rev'd on other grounds, *First Jersey*, 180 F.3d 504, involving related but not jointly administered proceedings, the bankruptcy court held that the individual and corporate Chapter 11 debtors' prepetition accounting firm did not hold or represent any interest adverse to the estates where the debtors had no claims against each other, the debtors and certain related parties represented by the accounting firm had no claims against each other, and the accounting firm and the debtors had no claims against each other.

Next, in *Marvel*, the Third Circuit held that a district court had erred in disqualifying a firm solely on the basis of an appearance of conflict posed by the firm's former representation of a creditor in the case. *Marvel*, 140 F.3d at 477-78. The Third Circuit found the firm's conflict neither potential nor actual on the following grounds: (i) the firm had never represented the creditor on a matter related to the bankruptcy; (ii) the firm, in anticipation of its selection as the trustee's counsel, had severed all attorney-client relations with the creditor; and (iii) the disclosures had revealed the firm's representation of the creditor and the creditor's grant to the firm of an unconditional waiver of conflicts. Id.

Finally, in *First Jersey*, 180 F.3d at 514, the Third Circuit held that a preferential stock transfer to counsel retained by the chapter 11 debtor-in-possession created an actual conflict of interest warranting disqualification. See also *Pillowtex*, 304 F.3d at 255 (holding that bankruptcy court had abused its discretion in approving a debtor's retention of a law firm, to which the debtor had made potentially preferential transfers, on the mere condition that the firm return the amount of any preferential payment and waive any resulting claim).

Exceptions to Governing Standard

Several exceptions to section 327(a) exist. First, in a Chapter 7 or 11 case, a person is not disqualified from employment under section 327 solely because of such person's employment by or representation of a creditor, unless another creditor or the United States Trustee objects, in which case the court must disapprove such employment if an actual conflict of interest exists. 11 U.S.C. § 327(c); *Brennan*, 187 B.R. at 146, 149 (holding that, absent conflict of interest, accountants' provision of services to debtor's landlord did not necessarily disqualify accountant from serving debtor in bankruptcy case).

Second, a person is not disqualified from employment under section 327 by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case. 11 U.S.C. § 1107(b). This exception does not apply, however, in cases in which the person is unable to satisfy section 327(a). *Michel v. Federated Dep't Stores, Inc*. (*In re Federated Dep't Stores, Inc*.), 44 F.3d 1310, 1318 (6th Cir. 1995).

Third, a trustee or debtor-in-possession may, with the court's approval, employ for a specified special purpose an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed. 11 U.S.C. § 327(e); *Brennan*, 187 B.R. at 155 (holding that attorney who represent-

ed corporate Chapter 11 debtor prepetition could be employed as special counsel to handle securities litigation where attorney possessed high degree of familiarity with case, estate's preference claim against attorney would not create any adverse interest between estate and attorney in connection with securities litigation, and other counsel could be employed as debtor's general counsel in bankruptcy proceeding).

Finally, an attorney or accountant employed to represent a creditors' or equity security holders' committee appointed by the United States Trustee may not, while employed by such committee, represent any other entity having an adverse interest in connection with the case. 11 U.S.C. § 1103(b). Representation of one or more creditors of the same class as represented by the committee does not per se constitute the representation of an adverse interest. Id.; *In re Oliver's Stores, Inc*., 79 B.R. 588, 596-97 (Bankr. D.N.J. 1987) (holding that attorneys and accounting firm representing unsecured creditors' committee could not represent individual committee members in lawsuits against debtor's former accounting firm where such firm could seek indemnification or contribution from debtor and its officers or employees, and hence, professionals might then represent separate, adverse interests in attempt to recover the same pool of damages).

Rules of Professional Conduct

Local Civil Rule 103.1(a) provides that the American Bar Association Rules of Professional Conduct, as revised by the New Jersey Supreme Court, govern the conduct of members of the District of New Jersey. L. Civ. R. 103.1(a). Local Bankruptcy Rule 1001-1 in turn incorporates the Local Civil Rules and renders them applicable to proceedings in the United States Bankruptcy Court for the District of New Jersey. D.N.J. LBR 1001-1. Thus, in determining whether a conflict of interest exists in a law firm's representation of parties in a bankruptcy proceeding, courts have relied on, in addition to section 327(a), the Rules of Professional Conduct. See, e.g., *In re Glenn Elec. Sales Corp*., 99 B.R. 596, 598 (D.N.J. 1988) (citing ABA Rules).

Disclosure of Conflicts

Any relationship or fact which might create a disqualifying conflict of interest must be disclosed initially in the retention application and thereafter on an ongoing basis. *Brennan*, 187 B.R. at 144. See also *In re Rancourt*, 207 B.R. 338, 361 (Bankr. D.N.H. 1997). Bankruptcy Rule 2014 and Local Rule 2014-1 address the procedural requirements associated with the filing of such a retention application. Subjective good faith efforts to comply with these rules are irrelevant. *Glenn*, 99 B.R. at 600. Moreover, breach of the duty of disclosure may result in disqualification and/or reduction of fees. *BH & P*, 949 F.2d. at 1318 (remanding matter to bankruptcy court for limited purpose of reassessing interim fee award by virtue of breach of duty of disclosure); *Glenn*, 99 B.R. at 600 (disqualifying debtor's counsel by virtue of counsel's failure to reveal in retention application receipt from creditor's affiliate of funds for payment of retainer).

Disallowance of Compensation

Except as provided in sections 327(c), 327(e), or 1107(b), the court may deny allowance of compensation for services and reimbursement of expenses of a professional person allowed under sections 327 or 1103 if, at any time during such professional person's employment under sections 327 or 1103, such professional person is not a disinterested person, or if such person represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed. 11 U.S.C. § 328(c); *First Jersey*, 180 F.3d at 514 n.9 (noting that "the Bankruptcy Court warned [firm retained by debtor and to which debtor had made preferential transfer] that if the transfer is avoided as to the payment of the pre-petition debt, '[the firm] is subject not only to disgorgement of the preference, but also to the possible denial or reduction of compensation under Code section 328(c) as well'" (quoting *Brennan*, 187 B.R. at 154)); *Fellheimer, Eichen & Braverman, P.C. v. Charter Techs., Inc*., 57 F.3d 1215, 1228-29 (3d Cir. 1995) (affirming denial of entire amount of fees claimed by Chapter 11 debtor's attorneys on basis of evidence indicating that attorneys, in attempt to deter creditors' effort to remove president from management of debtor's affairs, had undertaken representation of debtor's president); *In re XGW Excavating Co*., 111 B.R. 469, 473 (Bankr. D.N.J. 1990) (holding that unsecured creditors' committee counsel could not receive compensation for work performed after date on which it was alerted to conflict of interest arising from counsel's representation of particular creditor pursuing secured claim). ■