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## Teaching Selected Ethical Issues in Bankruptcy

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## TEACHING SELECTED ETHICAL ISSUES IN BANKRUPTCY

MICHAEL KORYBUT\*

Both consumer and business bankruptcies present numerous ethical questions.<sup>1</sup> Like any lawyer, the bankruptcy attorney must be familiar with a variety of ethics codes and rules, such as the 1969 American Bar Association (ABA) Model Code of Professional Responsibility<sup>2</sup> or the 1983 ABA Model Rules of Professional Conduct.<sup>3</sup> Further, the Bankruptcy Code has a number of provisions that raise ethical questions. Accordingly, when I teach my bankruptcy survey course, I devote time in a number of classes to ethical issues. In particular, I spend a good part of one class on Bankruptcy Code section 327(a) which prohibits an attorney representing the bankruptcy trustee from having any “interest adverse” to the bankruptcy estate and requires that the attorney be a “disinterested person.”<sup>4</sup> This essay describes how I teach that class in the context of a Chapter 11 corporate reorganization, principally through the analysis of section 327(a),<sup>5</sup> Federal Rules of Bankruptcy Procedure Rule 2014(a)<sup>6</sup> regarding disclosures, and *In re Filene’s Basement, Inc.*, penned by the estimable Chief Judge William Hillman.<sup>7</sup>

### I. BACKGROUND

Before discussing my class, let me provide some background information which the students would have already learned. Both individuals and entities, such as a corporation, may enter into a Chapter 11 reorganization.<sup>8</sup> In my class, I use a privately-held, medium-sized corporation as the model Chapter 11 debtor-in-bankruptcy. To enter a Chapter 11 reorganization, the

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1. In this essay, I confine my discussion of ethical questions to those raised by positive law, in particular the Bankruptcy Code.

2. MODEL CODE OF PROF’L RESPONSIBILITY (1969).

3. MODEL RULES OF PROF’L CONDUCT (1983).

4. 11 U.S.C. § 327(a) (2000).

5. *Id.*

6. FED. R. BANKR. P. 2014(a).

7. 239 B.R. 850, 852 (Bankr. D. Mass. 1999).

8. 11 U.S.C. § 302 (2000); *see also* U.S. Courts, Bankruptcy Basics, Chapter 11, <http://www.uscourts.gov/bankruptcycourts/bankruptcybasics/chapter11.html#background> (last visited June 15, 2007).

corporation files a bankruptcy petition.<sup>9</sup> Upon this filing, a bankruptcy estate—a separate legal entity from the corporation roughly analogous to an estate created upon a person’s death<sup>10</sup>—is created. The debtor-in-bankruptcy (or simply debtor) is the entity whose estate is administered in bankruptcy. The debtor’s estate contains all of the corporation’s “property” including any real estate, business or manufacturing equipment, and contracts.<sup>11</sup> Further, the debtor-in-bankruptcy must consider numerous relationships previously enjoyed by the corporation, including those with its management, employees, trade creditors, secured creditors, accountants, and lawyers.

In a typical Chapter 11 reorganization, rather than liquidate the debtor’s assets to pay the debtor’s creditors as much as possible from the liquidation proceeds, the debtor corporation continues its business under the protection of the bankruptcy laws and negotiates with its creditors to adopt a plan of reorganization that preserves profitable assets and activities.<sup>12</sup> Rather than the court appointing a bankruptcy trustee (a TIB) to supervise the corporate Chapter 11 reorganization, the debtor-in-bankruptcy exercises the trustee’s rights, powers, functions, and duties as debtor in possession (the DIP).<sup>13</sup> Generally, the DIP’s function in a Chapter 11 corporate reorganization is to operate the bankruptcy estate’s business, and negotiate and consummate the Chapter 11 bankruptcy plan.<sup>14</sup> As to the actual individuals acting as the DIP and operating the corporate debtor, for medium to small Chapter 11 corporate reorganizations, current management (or at least some of it) remains in charge on the theory that even though they rode the corporation into bankruptcy, these managers nevertheless have more experience running the company than would a court-appointed TIB.<sup>15</sup>

To assist its reorganization effort, the DIP may employ attorneys.<sup>16</sup> In the case of a Chapter 11 where the DIP acts for the bankruptcy estate, one might say that the debtor’s attorney is the estate’s attorney.<sup>17</sup> In considering attorneys to hire, the DIP must consider Bankruptcy Code section 327(a) which states that the “[DIP], with the court’s approval, may employ one or more attorneys . . . that do not hold or represent an interest adverse to the

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9. 11 U.S.C. § 301.

10. See William Houston Brown, 2 L. OF DEBTORS AND CREDITORS § 13:8 (2006).

11. See *id.*

12. See Joseph J. Bassano et al., 9B AM. JUR. 2D BANKRUPTCY § 1662 (2007).

13. See Brown, *supra* note 10, at § 13:1.

14. See Bassano, *supra* note 12.

15. See *id.*

16. 11 U.S.C. § 327(a) (2000).

17. More nuanced questions lurk about exactly who is the attorney’s client—the DIP, the estate, creditors of the estate, or shareholders of the estate—and which ethics rules apply according to the answer. See Nancy B. Rapoport, *The Need for New Bankruptcy Ethics Rules: How Can “One Size Fits All” Fit Anybody?*, 10 PROF. LAW. 20 (1998).

[bankruptcy] estate, and that are disinterested persons, to represent or assist the [DIP] in carrying out the [DIP's] duties . . . .”<sup>18</sup> Attorneys appointed under “[section] 327 . . . work with the debtor-in-possession but are responsible for working in the best interest of the estate.”<sup>19</sup>

When deciding whether to approve an attorney submitted by the DIP, the bankruptcy judge will consider the information disclosed in a Rule 2014(a) application for an order of employment of a professional person.<sup>20</sup> In relevant part, the application must provide

the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants . . . .<sup>21</sup>

To put teeth into section 327, Bankruptcy Code section 328(c) states that

the court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under section 327 . . . if . . . [such 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.<sup>22</sup>

Putting my students in the role of the DIP, I say, “Imagine it is your job to hire an attorney to help you with the Chapter 11 reorganization. Would any of you want to hire the law firm and its lawyers (the Firm) that had been general counsel to the corporation before it filed for bankruptcy?” Many students, remembering the assigned reading, say they would, offering various reasons. The Firm may have extensive knowledge about the corporation, its business, its legal affairs, its management, and its financial problems. I ask whether or not a new law firm could learn all these things, and we discuss how, in its early stage, a Chapter 11 reorganization is often a hasty whirlwind of an event, and that finding and educating new lawyers would be a time-consuming and disruptive undertaking.

Then I ask, “Why would the Firm want to be retained to represent the DIP?” With little hesitation a student usually says that representing the DIP in even a middle sized Chapter 11 reorganization would probably be very lucrative, and I readily agree. Another student may say that if the Firm is owed legal fees by the bankruptcy estate for work performed before the bankruptcy filing, as a creditor the Firm would have a keen interest in the reorganization. Yet another student may say that one of the Firm's partners may be on the

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18. 11 U.S.C. § 327(a).

19. Rapoport, *supra* note 17.

20. FED. R. BANKR. P. 2014(a).

21. *Id.*

22. 11 U.S.C. § 328(c) (2000).

Board of Directors, or be an officer, of the bankrupt company and thus may want to assist in the company's reorganization.<sup>23</sup>

Once we have finished this discussion, I congratulate the students for having given good reasons why both the DIP and the Firm would want such employment. Now their task is to obtain the bankruptcy court's approval to employ the Firm under section 327(a). When I ask whether anyone thinks section 327(a) raises some concerns, hands readily are raised, and students invariably say that the Firm's lawyers may have adverse interests to the bankruptcy estate or may not be disinterested persons, thus disqualifying them from employment. And so begins our discussion of *In re Filene's Basement, Inc.*, section 327(a), and Rule 2014(a).

## II. DISCLOSURE, ADVERSE INTERESTS, AND DISINTERESTEDNESS

I ask a student to recite the facts of *In re Filene's Basement, Inc.*<sup>24</sup> I put a timeline on the board, at the center of which I write the date August 23, 1999, the day Filene's Basement, Inc. and Filene's Basement Corp. (Debtors) filed for Chapter 11 bankruptcy.<sup>25</sup>

In 1981, T.A.C. Group, Inc. (TAC) hired Hale and Dore LLP (H & D), a large law firm to represent them in various matters.<sup>26</sup> One matter was drafting a confidentiality and nondisclosure agreement for TAC's President James McGowan.<sup>27</sup> Later, H & D also represented TAC in connection with McGowan's termination and his severance agreement.<sup>28</sup>

In July of 1998, the Debtor hired H & D as general counsel, which represented the Debtor in connection with corporate, litigation, and other matters.<sup>29</sup> In particular, H & D represented the Debtor's hiring of McGowan and began drafting an employment agreement before McGowan had signed his severance agreement with TAC.<sup>30</sup>

TAC sued the Debtors in state court (the State Court Action) regarding its hiring of McGowan and named McGowan as a defendant.<sup>31</sup> TAC alleged that McGowan used "T.A.C.'s trade secrets and confidential business information in violation of . . . [his] confidentiality and nondisclosure agreement drafted by [H & D] . . ."<sup>32</sup> At no time before or after the Debtors' bankruptcy filings did

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23. The last two points raise distinct ethical questions under section 327 and elsewhere, but I do not discuss them in this essay, although I do cover them during my bankruptcy survey course.

24. 239 B.R. 850 (Bankr. D. Mass. 1999).

25. *Id.* at 852.

26. *Id.* at 854.

27. *Id.* at 853–55.

28. *Id.* at 855.

29. *In re Filene's Basement*, 239 B.R. at 853.

30. *Id.* at 855.

31. *Id.* at 853.

32. *Id.*

H & D represent either TAC or the Debtors in the State Court Action.<sup>33</sup> However, three senior H & D partners were deposition witnesses.<sup>34</sup>

At this point I ask the students why H & D did not represent either party in the State Court Action, a question not addressed in Chief Judge Hillman's opinion. A nimble student quickly recalls Model Rule 1.7 which states, in relevant part, that an attorney may not accept representation of existing client A in a matter if such representation is "directly adverse" to another existing client B or if there is a "significant risk" that the representation of client A will be "materially limited by the lawyer's responsibilities to" client B or "by a personal interest of the lawyer."<sup>35</sup> The attorney, however, may represent clients A and B if she

reasonably believes that [she] will be able to provide competent and diligent representation to each affected client; . . . the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and each affected client gives informed consent . . . in writing.<sup>36</sup>

Having identified the rule, it is an easy argument to make that H & D could not represent either current client because the State Court Action is the assertion of a claim by one client against another client. So I continue pressing, asking why Model Rule 1.7 did not come into play much earlier, when H & D was deciding whether or not to represent the Debtors in drafting McGowan's employment agreement in connection with the Debtor hiring him? A student says that because H & D had represented TAC in negotiating McGowan's confidentiality agreement and his severance agreement, and particularly because McGowan had not yet signed the severance agreement, H & D's representation of the Debtor was "directly adverse" to TAC, or would act as a "material limitation" to H & D's representation of TAC. I press more, asking for a concrete example. A student says that H & D might not have advocated for the best termination and severance terms possible for TAC with respect to McGowan if H & D had known its client, the Debtors, were considering hiring McGowan. Another student takes the opposite position that because H & D had drafted McGowan's severance agreement, the firm may not be as aggressive as possible in negotiating McGowan's employment terms for the Debtors. Another student begins discussing Chief Judge Hillman's opinion in reference to section 327 and H & D's disinterestedness. I ask the

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33. *Id.* at 855.

34. *In re Filene's Basement*, 239 B.R. at 855.

35. MODEL RULES OF PROF'L CONDUCT R. 1.7(a) (2002). We use the Model Rules as amended through 2002, although this is not the version that would have been in effect in the time period of *In re Filenes's Basement*.

36. *Id.* at R. 1.7(b).

students to hold off the discussion until a bit later, but also to note that the same facts, which raise ethical concerns under Model Rule 1.7, often raise ethical concerns under section 327.

I commend the students on their arguments and ask whether H & D could avoid the Model Rule 1.7 problems simply by getting both clients' informed consent to the representation. I note that in the case, TAC alleged that H & D did not tell TAC of its representation of the Debtor in McGowan's hiring or get TAC's consent.<sup>37</sup> Then I ask, "What if H & D had informed TAC and the Debtors of the conflict in interest and asked for their respective written consents?" The astute student argues that given the fact that TAC is suing the Debtor over McGowan's hiring, his use of trade secrets, and breach of confidentiality, it is not likely TAC would have consented. Sometimes, another student will argue that the facts that gave rise to the State Court Action did not convince her that H & D could have "reasonably believed" that its representation of the Debtors would not adversely affect H & D's ability to competently and diligently represent TAC, and thus H & D should not ask TAC for its consent in the first place. I remind her that H & D did not ask for consent.<sup>38</sup>

After exploring Model Rule 1.7, we return to building our *In Re Filene's Basement, Inc.* timeline. The Debtors on August 23, 1999 filed Chapter 11 bankruptcy petitions.<sup>39</sup> Applications to employ H & D and Paul Daley, an attorney, accompanied the petitions.<sup>40</sup> The next day, Chief Judge Hillman approved the applications.<sup>41</sup> On September 3, 1999, TAC filed a motion with the Court to reconsider H & D's appointment, alleging that H & D was not a disinterested person, had a conflict of interest due to its representation of TAC, and held a potentially adverse interest to the Debtors' estate (the Motion).<sup>42</sup>

I note that Chief Judge Hillman, upon receiving additional information about H & D and its relationship to the Debtors and TAC, granted TAC's motion, vacated his prior approval, denied the Debtors' application to employ H & D, and directed H & D to return the Debtors' retainer.<sup>43</sup> Then we explore why.

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37. *In re Filene's Basement*, 239 B.R. at 854.

38. *Id.*

39. *Id.* at 852.

40. *Id.*

41. *Id.*

42. *In re Filene's Basement*, 239 B.R. at 852.

43. *Id.* at 859.

A. *The Disclosure Requirements of Section 327(a) and Rule 2014*

To begin our discussion, we first examine the disclosure requirements affected by section 327(a) and Rule 2014, and their explication by Chief Judge Hillman. He states that “the thrust of [section] 327 is to ‘ensur[e] that all professionals . . . tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities.’”<sup>44</sup> Further, we note Chief Judge Hillman’s observation that “[section] 327 imposes a duty on the bankruptcy court ‘which demands that the court root out impermissible conflicts of interest between attorney and client.’”<sup>45</sup> He says that Rule 2014 assists the court in this effort by requiring the applicant, here H & D, to “file a verified statement disclosing ‘the person’s connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants . . . .’”<sup>46</sup> Further, Chief Judge Hillman states that “[t]he purpose of the disclosure requirements is to provide the court with information necessary to determine whether the professional’s employment meets the broad test of being in the best interests of the estate.”<sup>47</sup> Finally, these requirements “transcend those of [section] 327(a), as they mandate disclosure of all connections with the named parties, rather than being limited to those which deal with disinterestedness. . . . Failure to be forthcoming with disclosure provides the bankruptcy court with an independent ground for disqualification.”<sup>48</sup>

After identifying the nature and broad purpose of the disclosure requirements, I ask the students to think about a large law firm like H & D that has many large, medium, and small clients. Then I ask them to think about all of the relationships medium-sized companies like the Debtors have with sellers, buyers, creditors, lawyers, and accountants. Combining the two groups potentially creates a large pool of actors. I then ask the students to imagine they are a junior associate working for such a large law firm, and they are asked to draft a Rule 2014 application for an order of employment with respect to a current corporate client that has just filed for Chapter 11 bankruptcy. They know about section 327(a) and Rule 2014(a)’s disclosure requirements, but how in fact do they perform them? In other words, how do they figure out whether their law firm, the applicant, has “connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants . . . .”<sup>49</sup>

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44. *Id.* at 855.

45. *Id.* at 857 (quoting *In re Martin*, 817 F.2d 175, 180 (1st Cir. 1987)).

46. *Id.* at 855 (quoting FED. R. BANKR. P. 2014(a)).

47. *In re Filene’s Basement*, 239 B.R. at 855–56 (quoting *In re Lincoln North Ass’n*, 155 B.R. 804, 807 (Bankr. D. Mass. 1993)).

48. *Id.* at 856 (citations omitted).

49. *Id.* at 855 (quoting FED. R. BANKR. P. 2014(a)).



The question is slightly unfair since our textbook does not provide much information about “conflict checks.” But the attentive student notices that H & D

compare[d] the Debtors’ list of their 20 largest unsecured creditors, the Debtors’ secured lenders, the Debtors’ landlords, and list of officers, directors and 5% shareholders, with [H & D’s] client database to identify creditors or shareholders with which [H & D] ha[d] any connection and made reasonable inquiry regarding whether any partners or employees of [H & D] own[ed] any equity interest in the Debtors.<sup>50</sup>

I commend the student for noticing this detail, and then explain that the cognoscenti call this a “conflicts check.” I also say that junior associates sometimes perform conflicts checks,<sup>51</sup> and that some students very well might do one within six months of arriving at their firms even if they do not practice bankruptcy. As *In re Filene’s Basement, Inc.* suggests, the task is serious business.

I then ask what H & D’s Rule 2014(a) statement (the Statement) accompanying the firm’s application for employment disclosed. The students note H & D’s first averment, as made by Daley, was that as far as Daley could ascertain, H & D (or any partner, counsel, or associate) did not hold or represent any interest adverse to the estate.<sup>52</sup> A student also observes that the Statement identified the Debtors as a current client for whom H & D served as general counsel, and provided an exhibit listing the Debtors’ creditors (or affiliates thereof), shareholders, and individuals who were clients of H & D and the services provided these clients.<sup>53</sup> Finally, the Statement said that H & D

has and continues to represent [TAC] . . . in connection with discrete financing and corporate matters entirely unrelated to the Debtors. T.A.C. is a plaintiff in a lawsuit naming the Debtors as defendants. [H & D] does not represent either party in such lawsuit and will not provide representation to T.A.C. in connection with any matters or dealings in these Chapter 11 cases.<sup>54</sup>

I then ask why the Statement’s disclosure was not sufficient for the court. This leads to a discussion of Chief Judge Hillman’s three complaints based on the additional information he obtained in TAC’s Motion to reconsider

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50. *Id.* at 853.

51. See Scott K. Brown, *How to Avoid “Ethically Incorrect” Behavior: Survival Tips Nobody Taught You in Law School*, 24 AM. BANKR. INST. J. 18 (2005) (giving tips to junior bankruptcy lawyers on reviewing conflict reports for their law firms).

52. See *In re Filene’s Basement*, 239 B.R. at 853.

53. See *id.*

54. *Id.*

employment. First, TAC stated that H & D's representation of TAC was more significant than H & D initially disclosed.<sup>55</sup> Chief Judge Hillman agreed, finding that the parties in fact enjoyed a continuing eighteen-year relationship during which TAC paid \$1,500,000 in legal fees.<sup>56</sup>

I then ask why H & D didn't disclose this relationship more fully? One student points out that H & D claims it was never TAC's general counsel.<sup>57</sup> Another student says that H & D did not consider TAC a "substantial client" because its legal fees were only one-tenth of one percent of H & D's annual billing fees in recent years.<sup>58</sup> On the last point, I question why this matters: Aren't Rule 2014(a)'s broad disclosure requirements to provide the court with information so that it can determine whether the applicant, here H & D, holds adverse interests to the debtor's estate and is a disinterested person? Where does it say that only "substantial clients," as defined by H & D, are ones to worry about? Further, even if a client is substantial, must all of H & D's connections with it be disclosed? I note that courts have held that even trivial connections must be disclosed.<sup>59</sup> I ask, "For law firms and corporate debtors with many respective legal and business relationships, is there a point at which the costs of more detailed disclosure outweigh the benefits?" And so we explore the tension between the costs and benefits of more disclosure.

After this discussion, we return to H & D's Statement and Chief Judge Hillman's second and third complaint.<sup>60</sup> Second, H & D did not disclose that the TAC/Debtors' State Court Action involved McGowan, who was the President of TAC and, at the time of the bankruptcy filings, had been the Debtor's vice-president, and that TAC was suing the parties over disclosure of trade secrets and confidential business information in breach of McGowan's confidentiality and nondisclosure agreement drafted by H & D.<sup>61</sup> Further H & D did not disclose that H & D represented TAC in McGowan's termination and Debtor's hiring of McGowan, and that three of H & D's partners were deposition witnesses in the State Court Action.<sup>62</sup> Third, the Statement did not

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55. *Id.* at 856.

56. *Id.*

57. *See In re Filene's Basement*, 239 B.R. at 856.

58. *See id.*

59. *See, e.g., In re Envirodyne Indus.*, 150 B.R. 1008, 1021 (Bankr. N.D. Ill. 1993) (stating with respect to Rule 2014(a) that it "leaves an attorney with no discretion to choose what connections are relevant or trivial to a § 327(a) analysis and should or should not be disclosed. No matter how trivial a connection appears to the professional seeking employment, it must be disclosed."); *In re Begun*, 162 B.R. 168, 177 (Bankr. N.D. Ill. 1993); *see also* Brown, *supra* note 51 (giving tips to junior bankruptcy lawyers on reviewing conflict reports for their law firms, and to associates who may be hesitant to bring up a conflict to a partner where "that partner has chided you in the past for chasing unimportant 'rabbit trails.'").

60. *See In re Filene's Basement*, 239 B.R. at 856.

61. *Id.* at 853, 856.

62. *Id.* at 856.

disclose that TAC and the Debtors were competitors, and that the Debtors business plan sought to open stores resembling TAC's.<sup>63</sup>

I ask why the court would want this information. Students say it is because section 327(a) calls for H & D to hold no adverse interest to the Debtors' estate and be a disinterested person,<sup>64</sup> and the Motion's additional facts raise serious questions about whether either requirement is met. I agree, and we begin a discussion of each.

#### B. *Adverse Interest and Disinterestedness*

First I ask, "What is the difference between the two concepts, and does the Bankruptcy Code help us understand what each means?"

A student points out that "adverse interest" is not defined in the Bankruptcy Code, and then provides Chief Judge Hillman's explication. Adverse interests means:

possess[ion] or assert[ion][of] mutually exclusive claims to the same economic interest, thus creating either an actual or potential dispute between rival claimants as to which . . . of them the disputed right or title to the interest in question attaches under valid and applicable law; or . . . [the possession of] a predisposition or interest under circumstances that render such a bias in favor of or against one of the entities.<sup>65</sup>

Further, "[t]he term 'interest adverse to the estate' may in fact be broader than it appears. . . . 'adverse interest' pertains to 'any interest, however slight, 'that would even faintly color the independence and impartial attitude required by the Code and Bankruptcy Rules.'"<sup>66</sup>

Another student states that the Bankruptcy Code does define a "disinterested person" to include "a person that . . . 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."<sup>67</sup> The student observes that given the substantive similarity between "adverse interest" and a "disinterestedness person," Chief Judge Hillman condones and follows the practice of many courts, favoring "a single determination of 'whether any competing interest of a court-appointed professional "created a meaningful incentive to act contrary to the best interest of the estate and its

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63. *Id.*

64. *See* 11 U.S.C. § 327(a) (2000).

65. *In re Filene's Basement*, 239 B.R. at 857 (quoting *Rome v. Braunstein*, 19 F.3d 54, 58 n.1 (1st Cir. 1994)).

66. *Id.* (quoting *In re Granite Partners*, 219 B.R. 22, 33 (Bankr. S.D.N.Y. 1998)).

67. 11 U.S.C. § 101(14) (2000), *amended by* Act of Apr. 20, 2005, 11 U.S.C.A. § 101(14) (West Supp. 2006).

sundry creditors—an incentive sufficient to place those parties at more than an acceptable risk—or the reasonable perception of one.”<sup>68</sup> Further, Chief Judge Hillman recites an additional test “relating to the appearance of impropriety; that is, even if there is not in fact a competing interest of the type described above, if there is a reasonable perception of such an interest, the applicant should be disqualified.”<sup>69</sup>

Having discussed the relevant law, I ask the students, “What are H & D’s actual conflicts of interest?” Students note that H & D represented TAC on various legal matters for eighteen years, H & D currently serves as Debtors’ general counsel, and TAC is suing Debtors in the State Court Action over McGowan.<sup>70</sup> If H & D were to be both the DIP’s counsel and the Debtors’ counsel, this would create an incentive to act contrary to TAC’s interest.

I ask whether this is true even though H & D in the State Court Action represents neither party.<sup>71</sup> A student typically points to Chief Judge Hillman’s observation that H & D is part of the proceedings in the sense that the litigation involves contracts drawn by H & D for both parties, these contracts’ interpretation, and the possible testimony of three of H & D partners.<sup>72</sup> Another student remembers that the Debtors have a business plan to mimic TAC’s stores, a plan presumably Debtors’ now will try to implement in their Chapter 11 reorganization.<sup>73</sup> If H & D serves as the DIP’s counsel, and the DIP’s goal is an effective reorganization, then H & D in effect will be helping the Debtors compete against TAC. This too creates an incentive to act contrary to TAC’s interest.

I then ask, “If H & D serves as the DIP’s counsel, what might give rise to a perception of a conflict of interest?” Students provide a number of reasons articulated by Judge Hillman. First, if the Debtors win the State Court Action because the court finds that McGowan’s termination and severance agreement (drafted by H & D) absolved the Debtors of any liability, then TAC might sue H & D for malpractice.<sup>74</sup> From this hypothetical situation rises an appearance of a conflict that might affect H & D’s representation of the Debtors’ estate. Similarly, if TAC should win the State Court Action, then the Debtors might seek indemnity from H & D who advised the Debtors with respect to McGowan’s employment.<sup>75</sup> If TAC prevailed and was awarded a large

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68. *In re Filene’s Basement*, 239 B.R. at 857 (quoting *Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994)).

69. *Id.*

70. *Id.* at 853.

71. *See id.* at 855.

72. *See id.* at 858.

73. *See In re Filene’s Basement*, 239 B.R. at 856.

74. *See id.* at 858.

75. *See id.*

amount of damages, or if the Debtors were enjoined from employing McGowan, that might adversely affect the Debtors ability to reorganize.<sup>76</sup>

I then ask whether there's any risk of being overly inclusive if one focuses not on actual conflicts but hypothetical potential conflicts or perceptions of conflicts. I quote one court that said that "merely hypothesizing that conflicts may arise" is not sufficient grounds for disqualification.<sup>77</sup> Is there a problem with allowing potential conflicts to disqualify a law firm from representation where no one knows with certainty if the potential conflict's triggering events will transpire? How does one quantify the probability that a trigger event will occur? If one is too trigger-happy, for large, complex Chapter 11 debtors for whom there may be few good law firms capable of representation, will such a debtor be conflicted out of competent counsel?

We close our discussion by noting that Chief Judge Hillman holds that "H & D has failed fully to disclose its connections with parties in interest as required by Rule 2014 and that it lacks disinterestedness in this case either because of an actual present adverse interest or the appearance of one."<sup>78</sup> I remind students that Chief Judge Hillman vacated his prior approval of H & D, denied the Debtors' application to employ H & D, and directed H & D to return the Debtors' retainer.<sup>79</sup> But I also say that H & D in one sense was lucky. Their representation of the Debtors in their Chapters 11 was relatively short-lived, and thus H & D did not stand to lose much in unpaid legal fees with respect to that representation. Further, Chief Judge Hillman allowed H & D to apply for reimbursement of actual and necessary expenses it incurred.<sup>80</sup> Other attorneys have not been so lucky. In one case, for example, where an attorney for a Chapter 11 corporate debtor simultaneously represented the debtor's principal shareholder, the court held that there was a conflict of interest sufficient to deny under section 328(c) all compensation to the attorney for fees and expenses incurred in connection with the Chapter 11 case, and required that the attorney disgorge all sums and retainers received as payment for legal fees in connection with the case.<sup>81</sup> In another case, a bankruptcy attorney was convicted of the felony offense of knowingly and fraudulently making a false material declaration in a bankruptcy case where he failed on his Rule 2014 statement to disclose his firm's representation of the debtor's largest secured lender and one of the secured lender's controlling partners.<sup>82</sup> Now that's ethics with bite.

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76. *See id.*

77. *In re Stamford Color Photo, Inc.*, 98 B.R. 135, 138 (Bankr. D. Conn. 1989).

78. *In re Filene's Basement*, 239 B.R. at 858.

79. *Id.* at 859.

80. *Id.*

81. *In re Westwood Homes, Inc.*, 157 B.R. 182, 184–85 (Bankr. D. Me. 1993).

82. *United States v. Gellene*, 182 F.3d 578, 585–86 (7th Cir. 1999).