Written Materials
Conflict of Interest in Bankruptcy Litigation

In re Oklahoma P.A.C. First Ltd. Partnership
122 B.R. 387; 1990 Bankr. LEXIS 2542; 24 Collier Bankr. Cas. 2d (MB) 1057

FACTS

- The debtor, an Arizona limited partnership owning $50 million in real property, filed for Chapter 11 bankruptcy
- There were five secured creditors—City of Lafayette, CO; Crossland Mortgage Corporation; Valley National Bank; Kansas City Life Insurance Company; and Valley National Mortgage Corp.—all represented by the same law firm
- The debtor requested that the creditors' counsel comply with Federal Rule of Bankruptcy 2019, which requires counsel to submit a verified statement concerning its representation of multiple creditors
- If there is a failure to comply with Rule 2019, the Court may refuse to permit the entity acting on behalf of the parties from being heard further in the Chapter 11 case

ISSUE

Whether the same law firm can represent multiple creditors in a bankruptcy proceeding in compliance with Federal Rule of Bankruptcy 2019

RELEVANT AUTHORITY

- Federal Rules of Bankruptcy 2019
  - In a . . . . chapter 11 reorganization case, except with respect to a committee appointed pursuant to § 1102 of the Code, every entity or committee representing more than one creditor or equity security holder and, unless otherwise directed by the court, every indenture trustee, shall file a verified statement with the clerk setting forth (1) the name and address of the creditor or equity security holder; (2) the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition; (3) a recital of the pertinent facts and circumstances in connection with the employment of the entity . . . .; and (4) with reference to the time of employment of the entity, ... the amounts of claims or interest owned by the entity . . . ., the amounts paid therefor, and any sales or other disposition thereof.

ARGUMENTS

Debtor: A law firm simultaneously representing multiple *individual* creditors in the same proceeding falls under the purview of Rule 2019

Creditors: (1) Rule 2019 was not intended to apply to individual creditors or counsel representing numerous creditors—there is an exception for committees created under 11 U.S.C. § 1102; (2) A bankruptcy court should not be involved in the "administration" of the bankruptcy case; and (3) Rule 19 is in contravention with § 1109(b) of the Bankruptcy Code ("A party in interest … may raise and appear and be heard on any issue in a case under this chapter").

COURT'S RULING

- Priority of Liens: The interests of these two creditors are not aligned—if Crossland gets the first lien, City of Lafayette becomes an unsecured creditor and Crossland becomes an undersecured creditor. As an undersecured creditor, City of Lafayette would lose the ability to receive postpetition interest or be treated as a secured or undersecured creditor in the debtor's reorganization plan
- Rule 2019: It is part of the chapter 11 reorganization process that all matters should be done openly and subject to scrutiny, whether it is the proposal of a plan of reorganization, representation of a debtor, or representation of numerous creditors—secured or unsecured.
- The court ordered creditors' counsel to comply with Rule 2019 and withdraw from representing at least one of the creditors because the firm can't aggressively represent the interests of both creditors
- The court confirmed that counsel representing multiple creditors in a bankruptcy had to comply with Rule 2019 and that, as a result of those disclosures, counsel could be forced to withdraw from representation of some creditors where a conflict of interest was found.

In re Whitman

101 B.R. 37 (Bankr. N.D. Ind. 1989)

FACTS

- Doerflein Insurance Service held both an unsecured claim against the debtor's estate and a secured claim
- Doerflein's attorney was authorized to serve as counsel for the unsecured creditors committee even though the same attorney was, by virtue of representing Doerflein's Insurance Service, a member of the unsecured creditors committee

ISSUE

Whether an attorney can represent a secured member of the unsecured creditors committee while simultaneously being a member of the unsecured creditors committee

RELEVANT AUTHORITY

11 U.S.C. § 1103

(b) An attorney or accountant employed to represent a committee appointed under section 1102 of this title may not, while employed by such committee, represent any other entity having an adverse interest in connection with the case. Representation of one or more creditors of the same class as represented by the committee shall not per se constitute the representation of an adverse interest

COURT'S RULING

- Doerflein, with its dual status as both a secured and unsecured creditor, has an interest in maximizing its recovery on both claims—to effectively pursue these interests, it would require counsel to take a position that will be adverse to the interests of the creditors committee and the unsecured creditors generally
- The interests of Doerflein and its principals, as secured creditors, are dramatically different from the interests of the other unsecured creditors—an actual and irreconcilable conflict exists between them
- Every dollar by which the amount of the secured claim is increased and every dollar which must be paid on account of that secured claim, will of necessity diminish the assets available for distribution on account of unsecured claims
- A committee must necessarily be adversarial to adequately represent the different interests of the creditors—its meat to be a partisan pursuant to its own self interest
- The simultaneous representation of a creditor holding a secured claim and the unsecured creditors committee is, as a matter of law, a conflict of interest prohibited by 1103(b)
- Counsel can either cease representing his creditor/client or cease representing the committee—counsel, the creditor, and the committee should be given their choice as to which path will be taken

In re Caldor, Inc.
193 B.R. 165 (Bankr. S.D.N.Y. 1996)

FACTS

- Bradlees and Caldor were two mid-to high-end discount retail merchandisers who filed separate chapter 11 cases
- Bradlees' unsecured creditors committee retained Otterbourg as its counsel; Caldor's unsecured creditors committee was seeking to also retain Otterbourg as its counsel
- Caldor's Trustee objected to its unsecured creditors committee retaining Otterbourg, citing a potential conflict of interest

ISSUE

Whether an attorney can simultaneously represent the unsecured creditors committees of debtors who are economic competitors

RELEVANT AUTHORITY

11 U.S.C. § 1103

(b) An attorney or accountant employed to represent a committee appointed under section 1102 of this title may not, while employed by such committee, represent any other entity having an adverse interest in connection with the case. Representation of one or more creditors of the same class as represented by the committee shall not per se constitute the representation of an adverse interest

Code of Professional Responsibility Canons 4, 5 and 9 ("Courts look to the Code of Professional Responsibility in analyzing conflicts under the Bankruptcy Code")

- Canon 4: Requires a lawyer to preserve the confidences and secrets of his client
- Canon 5: Mandates that an attorney exercise independent professional judgment on behalf of the client
- Canon 9: Provides that the attorney should avoid even the appearance of impropriety

ARGUMENTS

- Trustee: (1) Because Bradlees and Caldor compete in the same market niche, the interests of the Committees are adverse (§ 1103(b)) and counsel is therefore barred from representing the Caldor committee—even though Bradlees does not have a claim in and is not a party to the Caldor proceeding; (2) Counsel is barred from representing the Caldor committee under Canons 4, 5 and 9 of the Code of Professional Responsibility
- Committee: (1) If the Trustee's objection is sustained the chapter 11 cases will be disrupted resulting in unwarranted delay in the reorganization process; (2) The interests of the committees are not adverse because Caldor and Bradlees are not creditors of each other and the committees do not compete with one another; (3) Caldor retaining counsel is not barred by the Code of Professional Responsibility.

COURT'S RULING

Adverse Interests (§1103(b))

- Generally an "adverse interest" takes the form of a competing economic interest tending to diminish estate values or to create a potential or actual dispute in which the estate is a rival claimant—here, neither the debtors nor the committees hold or assert claims against each other and none assert competing claims to an economic interest.
- Although the two debtors are economic competitors, the committees do not hold disqualifying "adverse interests" for purposes of § 1103(b), because neither the committees, nor the debtors, are likely to become rival claimants.
- Interests are not considered "adverse" merely because it is possible to conceive a set of circumstances under which they might clash, i.e., a possible merger between the debtors; a possible buyout between the debtors; or other "hypothetical conflicts"
- § 1103(b) prohibits simultaneous representation of a committee and an entity with an interest adverse to the committee only where the attorney represents the other entity on a matter related to the bankruptcy case
- Counsel deployed an information barrier with two teams of professional employees—one team renders services to the Bradlees committee and the other team renders services to the Caldor committee

COURT'S RULING (cont'd)

Code of Professional Responsibility (Canons 4, 5 and 9)

- Courts look to the Code of Professional Responsibility in analyzing conflicts under the Bankruptcy Code
- Canon 4 is not violated—(1) the interests are not adverse; (2) there is no current or proposed litigation between the debtors or the committees; (3) the debtors are not party to the same bankruptcy case; and (4) neither committee is likely to be in a position to take advantage of attorney-client confidences disclosed by the other to the attorney
- Canon 5 is not violated—(1) the activities that counsel for the Caldor committee would perform, such as investigating the priority of liens or investigating debtors financial condition, are not likely to affect Bradlees or Bradlees committee; (2) there is no support for the proposition that the representation of economic competitors violates Canon 5; and (3) neither the Caldor committee nor the Bradlees committee have objected to the simultaneous representation
- Canon 9 is not violated—although the debtors are economic competitors, the committees themselves are not competitors in any forum—their bankruptcy matters are completely separate

19

COURT'S RULING (cont'd)

- The trustee's objection to the Caldor committee retaining the same counsel as the Bradlees committee was overruled—the committees were found to not hold disqualifying adverse interests in connection with the cases as required under the statute because the bankruptcy cases were completely separate

20

In re Muscle Improvement, Inc.
437 B.R. 389 (Bankr. C.D. Cal. 2010)

21

FACTS

- Muscle Improvement Inc. (debtor) brought an adversary proceeding against their principal creditor Allstate Financial Group on a number of claims, including breach of contract and fraud.
- Allstate appeared through its counsel, Haleh Naimi, and her law firm.
- Seeking to possibly retain her, the debtor conducted two consultations with Naimi prior to their bankruptcy filing—Naimi reviewed the debtor's financial condition, examined documents and offered advice on preferential payments
- Debtors moved to disqualify Naimi and her firm from representing Allstate on conflict of interest grounds

22

ISSUE

(1) Whether an attorney should be disqualified on conflict of interest grounds if the attorney met with a debtor and subsequently represented a creditor in the same proceeding
(2) Whether the subject matter of the debtor meetings is substantially related to the subject matter with the current case
(3) Whether Naimi's relationship with debtors was one in which confidential information would ordinarily be disclosed

23

RELEVANT AUTHORITY

- Local Rule 2090-2(a) of the Bankruptcy Court for the Central District of California, which requires that attorneys comply with the California Rules of Professional Conduct, governs the professional responsibility of attorneys practicing before this court.
- Rule 3-310 of the California Rules of Professional Conduct requires an attorney to avoid the representation of adverse interests.
  (E) A member shall not, without the informed written consent of the client or former client, accept employment adverse to the client or former client where, by reason of the representation of the client or former client, the member has obtained confidential information material to the employment
- -The "Substantial Relationship Test"
  - Governs attorney disqualification motions under Rule 3-310(E) in California
  - To prevail, the former client must satisfy two elements: (1) the subject matter of the attorney's current representation is substantially related to the subject matter of the attorney's earlier representation of the client; and (2) the attorney's earlier representation of the former client was one in which confidential information would ordinarily be disclosed
  - A former client that establishes both of these elements creates an irrebuttable presumption that the attorney possesses confidential information
  - Under California rules, the relationship of attorney and client is established prima facie at the time of preliminary consultations with a view toward retention, even if actual retention does not materialize

24

ARGUMENTS

- Debtor: Since confidential information was exchanged during the consultations between debtor and Naimi, Naimi should be disqualified under Rule 3-310(E)
- Creditor: (1) The only financial information Naimi received is information that is now public—a former client's information is not confidential for conflict of interest purposes if it is already available to the adverse client; (2) at the second meeting, a financial consultant attended the meeting which prevented the meeting from being confidential

COURT'S RULING

- The substantial relationship test is met: (1) Naimi consulted with debtors with respect to the same case in which she is now representing Allstate, the principal creditor—the subject matter (debtors' financial condition) is essentially the same and thus is substantially related; (2) The consultation with the debtors was one in which confidential information would ordinarily be disclosed—debtors have evidence that they presented substantial confidential information and received her legal advice on several subjects
- The financial consultant in the second meeting was within the sphere of confidentiality for the debtors—therefore, the consultant's presence did not destroy debtors' reasonable expectations of confidentiality
- The court notes that to avoid this problem, Rule 3-310(E) provides an answer: Counsel may obtain written consent from those who attend the consultation to represent another party in the case if counsel is not retained by the parties to the consultation
- An attorney must be disqualified on conflict of interest grounds if the attorney meets with a client under circumstances in which confidential information would likely be disclosed, and the attorney subsequently represents an adverse client in a substantially related matter, even if the former client never employed the attorney.

In re Midway Motor Sales, Inc.
355 B.R. 26 (Bankr. N.D. Ohio 2006)

FACTS

- Midway Motor Sales, Inc. (debtor) brought an adversary proceeding in bankruptcy to determine the status and validity of a creditor's secured claim
- The Trustee moved for approval to employ creditor's counsel, who represented two unsecured creditors, on a contingency basis to determine the validity of an allegedly secured creditor's claim

ISSUE

Whether a conflict of interest exists when a creditor's attorney representing unsecured claims is employed by the Trustee on a contingency basis to determine the validity of a creditor's secured claim?

RELEVANT AUTHORITY

Employment of professional persons is governed by section 327 of the Bankruptcy Code

(a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

(c) In a case under chapter 7, 12 or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest

Definition of "disinterested person"—11 U.S.C. § 101(14)(E)

- The term "disinterested person" is defined as 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

Roberts test — "hold an interest adverse to the estate" if two or more entities:
(1) possess an economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant; or (2) to possess a predisposition under circumstances that render such a bias against the estate

ARGUMENTS

- Trustee: There is no conflict of interest because the attorney would be used for a special, limited purpose so that the interests of the creditor and debtor are actually aligned
- Creditor (GMAC): (1) The attorney is not a "disinterested person" if he is representing the creditor; and (2) the creditor's and debtor's interests are not aligned because if the Trustee succeeds in reducing the amount of the creditor's secured claim, the creditor will have a smaller claim for which it will receive full payment and, thus, a greater unsecured claim.

COURT'S RULING

Section 327 of the Bankruptcy Code

- Although the attorney is not disinterested because of his representation of the general unsecured creditors, pursuant to 11 U.S.C. § 327(c), such a representation does not disqualify the attorney from representing the Trustee for a special purpose
- Sections 327(a) and (c) do not prohibit the Trustee from employing the attorney for a special purpose unless the attorney holds an interest adverse to the estate or has an actual conflict of interest for which he is employed
- Here, not only is the attorney's interest is not adverse, it is aligned with the Trustee's interest

Roberts test – "hold an adverse interest"

- Here, the court applies the test and finds that the attorney does not have an adverse interest to the estate or an actual conflict of interest for the special purpose for which he is to be employed
  - (1) Without the employment of the attorney on a contingency fee basis, the Trustee will be forced to abandon assets because the estate does not have money to pay counsel to pursue such assets—so, the interests of the attorney and Trustee are aligned in seeking to minimize the secured claim and collect assets for the benefit of all creditors in the estate
  - (2) The attorney does not "possess a predisposition under circumstances that render such a bias against the estate" because the interest of the attorney aligns with the estate's interest in limiting the secured claim and collecting assets for the estate

COURT'S RULING (cont'd)

- An attorney who is not a disinterested person cannot represent the Trustee in general in the bankruptcy.
- However, that attorney is not precluded from representing the Trustee for the special purpose of determining the validity of the creditor's claim under §327(c) in the absence of an actual conflict of interest.
- Such special representation is appropriate when the interests of the attorney and the shareholders are aligned in maximizing the estate for unsecured creditors by minimizing the creditor's claim, and in preserving assets which the estate would otherwise be forced to abandon for lack of litigation funds.

In re Matco Elecs. Group

383 B.R. 848 (Bankr. N.D. N.Y. 2008)

FACTS

- Trustee is seeking disallowance and disgorgement of fees already paid to BHPP, the law firm who represented the Committee of Unsecured Creditors
- Jaco Electronics was a member of the Committee and the holder of a significant claim
- The Committee sought to retain BHPP as counsel to the Committee
- Terenzi, the attorney who would be primarily responsible for the case, filed an affidavit disclosing the firm's potential conflicts of interest: "…an attorney is related to an officer and shareholder of one of the general unsecured creditors of the debtors."
- Spelfogel was the attorney with the potential conflict—he was the son-in-law of the CEO and President of Jaco, and his wife became the in-house counsel at Jaco; Jaco was a Committee member and holder of a significant claim
- Spelfogel left BHPP still representing the Committee and took his representation of that Committee to his new firm, Nixon

ISSUE

Whether fees already paid to a law firm, which served as counsel to the committee of unsecured creditors, can be disallowed and disgorged even if the law firm produced a disclosure pursuant to Federal Rules of Bankruptcy 2014

RELEVANT AUTHORITY

Federal Rule of Bankruptcy 2014: Employment of Professional Persons

- Application for an order of employment. An order approving the employment of attorneys … shall be made only on application of the trustee or committee. . . . The application shall state specific facts showing the necessity for the employment, 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, in their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. The application shall be accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.

ARGUMENTS

- Trustee: (1) BHPP's Application for Retention was purposely vague with regard to Spelfogel's relationship to Jaco, thereby depriving the Court and other parties in interest of the opportunity to fully consider that relationship in deciding whether or not to appoint BHPP as counsel to the committee; (2) All facts that in any way bear on the issue of disinterestedness must be fully disclosed—failure to make such disclosure warrants denial of all compensation for postpetition services; (3) BHPP's vague and incomplete disclosure of Spelfogel's relationship to the CEP of Jaco was intended to, and did in fact, cause the Trustee and Court to overlook an otherwise disqualifying factor; (4) An award of fees to BHPP will adversely impact on the holders of other administrative claims in cases that are dangerously close to being administratively insolvent.
- BHPP: (1) Terenzi was the lead attorney when BHPP was representing the Committee—Spelfogel took over representation when he went to Nixon; (2) BHPP at no time represented Jaco in any matter; (3) It was only during Nixon's representation of the Committee that Spelfogel's wife began working for Jaco as in-house counsel; (4) §1103(b) does not disqualify a law firm from representing a creditors committee simply because an attorney in the firm is related by marriage to one of the committee members.

COURT'S RULING

- Federal Rule of Bankruptcy 2014 requires a significant level of disclosure—the level of disclosure outlined is mandatory, whether or not that disclosure would unearth a conflict of interest
- While Spelfogel's relationship to Jaco may not have created a per se conflict of interest at the time of BHPP's appointment, subsequent developments suggest that it may have created an atmosphere of hostility between the Committee and the Debtors
- Had a more detailed disclosure of Spelfogel's relationship to Jaco been made in the initial disclosure, the Court may have been reluctant to appoint BHPP in order to avoid the very dilemma that subsequently developed
- The disclosure made in the initial affidavit regarding Spelfogel's relationship to Jaco appears to have been purposefully vague—based on the significance of the roles taken on in the cases by both Spelfogel and Jaco, roles that had to have been known by BHPP
- The appropriate remedy is fee disallowance—whether the initial disclosure was vague because of careless disregard or because it was an intentional effort to be vague
- The disclosure made in the initial 2002 affidavit regarding a certain attorney's relationship to a significant claim holder appeared to have been purposefully vague. The balance of the fees requested by the firm in its fee application was denied as a direct result of its failure to fully and fairly comply with the disclosure requirements of Federal Rule of Bankruptcy 2014.

Conflicts in Bankruptcy Litigation:
Entering into Business with a Client

State ex rel. Nebraska State Bar Ass'n v. Thor
237 Neb. 734; 467 N.W.2d 666; 1991 Neb. LEXIS 158

FACTS

- Nebraska State Bar Association is bringing this action against attorney Thor, charging him with violating the Nebraska Code of Professional Responsibility.
- Thor was retained by the Rathkes. The Rathkes were farmers who owned farmland, were experiencing financial trouble and were considering bankruptcy
- After advising them to take advantage of a law that would exempt annuities in chapter 7 bankruptcy, the Rathkes informed Thor they wished to file a chapter 7 bankruptcy
- Thor encouraged the Rathkes to list their 151 acre property—property of the bankruptcy estate— through Thor Realty (also a client and owned by attorney Thor's father; Thor Realty would take a 5 percent commission) so they could take advantage of the annuities exemption
- Thor offered to purchase the property and did not disclose he was making the offer on his own behalf—as a result of the offer, he was given the appraisal and minimum purchase price
- Thor bought the 151 acre property after failing to inform the Rathkes, the bankruptcy court and the secured creditors that other farmers had inquired about purchasing the Rathkes' land

ISSUE

Whether an attorney who is representing a debtor in bankruptcy can purchase the debtor's property that is subject to the bankruptcy litigation

RELEVANT AUTHORITY

Code of Professional Responsibility

- Canon 1, DR 1-102 Misconduct
  - (A) A lawyer shall not:
    - (1) Violate a Disciplinary Rule
    - . . . .
    - (4) Engage in conduct involving dishonesty, fraud, deceit, or misrepresentation
    - (5) Engage in conduct that is prejudicial to the administration of justice
    - (6) Engage in any other conduct that adversely reflects on his fitness to practice law.
- Canon 5, DR 5-103 Avoiding Acquisition of Interest in Litigation
  - (A) A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation he is conducting for a client, except that he may:
    - (1) Acquire a lien granted by law to secure his fee or expenses
    - (2) Contract with a client for a reasonable contingent fee in a civil case
- Canon 5, DR 5-104 Limiting Business Relations with a Client
  - (A) A lawyer shall not enter into a business transaction with a client if they have differing interests therein and if the client expects the lawyer to exercise his professional judgment therein for the protection of the client, unless the client has consented after full disclosure

ARGUMENTS

- Bar Association: Thor should be sanctioned because he (1) took actions that were inconsistent with the best interests of his client, and (2) deliberately concealed those actions from the court, the creditors and other interested parties.
- Thor: (1) The Rathkes would not receive any proceeds from the sale, so he was not acting contrary to their best interests; and (2) he told them to seek advice from another attorney regarding the sale of the land.

COURT'S RULING

Canon 5, DR 5-103 Avoiding Acquisition of Interest in Litigation

- Thor violated DR 5-103 by purchasing the property while the property remained subject to litigation—the property was going to be abandoned, but the purchase occurred during the period where creditors could have objected to the abandonment and a hearing would have occurred.

Canon 5, DR 5-104 Limiting Business Relations with a Client

- Thor and the Rathkes had differing interests in the transaction—the interest of Thor as purchaser and the interest of the Rathkes as sellers are clearly in conflict; this conflict prevented Thor from giving the Rathkes full and disinterested advice
- Thor did not exercise his professional judgment for the protection of his client—the Rathkes expected Thor to assist them so that their financial problems were handled in such a way as to benefit them and not unnecessarily hurt creditors and Thor did not meet that expectation
- The Rathkes did not consent to the transaction with full disclosure from Thor—although the Rathkes knew Thor was purchasing the property, this is not full disclosure and does not relieve Thor of his duty to inform the Rathkes of the effect the conflict of interest might have on his representation of the Rathkes

Canon 1, DR 1-102 Misconduct

- Thor is guilty of misconduct—Thor was using his position as attorney handling the Rathkes' bankruptcy litigation to obtain knowledge and the inside track in his purchase of the property out of the bankruptcy estate, while excluding everyone else from having the opportunity to make offers
- Thor's real estate transaction involved dishonesty, fraud, misrepresentation, and deceit; he went to great lengths to conceal his conflict of interest—this concealment amounted to fraud and misrepresentation in violation of DR 1-102

COURT'S RULING (cont'd)

- The court entered a judgment of suspension against Thor for one year.
- Thor failed to deal completely and honestly with the facts as they were known to him, had deliberately covered up some facts, and had not acted in the complete interest of his clients. By acquiring an interest in his client's property, Thor was in conflict with his clients' interests. The clients depended on Thor and Thor failed to fully disclose his conflict.

In re Cohagen-Deubel

LEXIS 516 (U.S. Bankr. D. Colo. May 17, 2002)

FACTS

- Attorney Kindsfather conducted a fee payment scheme where he would file an attorney's lien on houses owned by clients for fees related to bankruptcy representation as debtor's counsel in 47 cases
- After his clients filed their bankruptcy petition, Kindsfather would file a Lien Statement and/or redeem his client's property when in foreclosure, and in some cases, would obtain title to his client's property, after which he would sell the property for a profit—often far exceeding the attorney fees earned
- By virtue of the Lien Statements, Kindsfather became an undisclosed secured creditor whose debt was not subject to the homestead exemption in the cases where he had his clients sign a Lien Statement
- Kindsfather did not disclose this practice to anyone, at any time, or under any circumstances, until after the problem was raised by a United States Trustee

ISSUE

Whether an attorney who conducts a fee payment scheme by acquiring a security interest from a client is in violation of the Bankruptcy Code and/or Federal Rules of Bankruptcy

RELEVANT AUTHORITY

Section 329 of the Bankruptcy Code
(a) Any attorney representing a debtor in a case under this title, or in connection with such a case, whether or not such attorney applies for compensation under this title, shall file with the court a statement of the compensation paid or agreed to be paid … and the source of such compensation

Federal Rules of Bankruptcy Procedure 2016
(b) Disclosure of compensation paid or promised to attorney for debtor. Every attorney for a debtor, whether or not the attorney applies for compensation, shall file and transmit to the United States trustee within 14 days after the order for relief, or at another time as the court may direct, the statement required by § 329 of the Code including whether the attorney has shared or agreed to share the compensation with any other entity. The statement shall include the particulars of any such sharing or agreement to share by the attorney, but the details of any agreement for the sharing of the compensation with a member or regular associate of the attorney's law firm shall not be required. A supplemental statement shall be filed and transmitted to the United States trustee within 14 days after any payment or agreement not previously disclosed.

Colorado Rules of Professional Conduct Rule 1.8
(a) A lawyer shall not enter into a business transaction or knowingly acquire an ownership, possessory, security, or other pecuniary interest adverse to a client unless:
(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which can be reasonably understood by the client; (2) the client is informed that use of independent counsel may be advisable and is given a reasonable opportunity to seek the advice of such independent counsel in the transaction; and (3) the client consents in writing thereto.

ARGUMENTS

- Trustee: Kindsfather should be sanctioned because he engaged in a fee payment scheme that created a conflict of interest; that his interests were adverse to his clients; and that failure to disclose his scheme to anyone, at anytime, constitutes a violation of the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure
- Kindsfather: The failure to disclose, or later supplement his disclosures regarding the Lien Statements and acquisition of clients' homes, was merely a mistake—his error was the product of oversight, misunderstanding, or simple negligence.

COURT'S RULING

11 U.S.C. § 329 and Federal Rule of Bankruptcy Procedure 2016(b)

- Kindsfather utterly failed to meet the disclosure requirements of these two rules
- Kindsfather improperly circumvented the Bankruptcy Code provisions vesting oversight of attorneys in Bankruptcy Court by having his clients sign a pre-petition letter directing the Chapter 13 Trustee to pay any monies held to him, and then deducting his unpaid fee from such monies prior to returning the balance to the debtor

Colorado Rules of Professional Conduct Rule 1.8

- Kindsfather violated 1.8(a)(1)—he acquired a "security or other pecuniary interest" adverse to his clients—he enhanced his position as a creditor, pre-empted his client's exemption rights, and put himself in the position to end up owning his client's homes
- Kindsfather violated 1.8(a)(2)—he did not recommend that his clients consult with independent counsel regarding the Lien Statement

The court ordered sanctions, including the disgorgement of fees, a monetary penalty assessment, and a non-monetary sanction of ethics and continuing legal education requirements. Counsel was further ordered to disgorge all profit, or net proceeds, which counsel received from the redemption and sale of his client's home.

Office of Lawyer Regulation v. Trewin (In re Trewin)
2004 WI 116; 275 Wis. 2d 116; 684 N.W.2d 121; 2004 Wisc. LEXIS 664

FACTS

- This is an action brought by the Office of Lawyer Regulation seeking sanctions on attorney Trewin alleging he engaged in professional misconduct with respect to his representation of a number of clients in bankruptcy or debt reorganization proceedings
- Trewin is a bankruptcy attorney who would repeatedly lend money to his clients in financial trouble and during their bankruptcy proceedings
- As part of the scheme, Trewin and his brother-in-law obtained a security interest in Trewin's clients' real estate, businesses and personal property
- Trewin never disclosed to his clients the conflict of interest that was created by his lending them money and acquiring their assets

ISSUE

Whether a debtor's attorney entering into lender-debtor or business relationships with the debtor constitutes professional misconduct which warrants sanctions

RELEVANT AUTHORITY

Wisconsin Supreme Court Rule 20:1.8

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which can be reasonably understood by the client;

(2) the client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and

(3) the client consents in writing thereto.

Wisconsin Supreme Court Rule 20:1.7

(b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:

(1) the lawyer reasonably believes the representation will not be adversely affected; and

(2) the client consents in writing after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

ARGUMENTS

- OLR: (1) Written client consent required by SCR 20:1.8(a)(3) cannot be satisfied solely by the client signing the loan documents—the rule requires the client to consent in writing to the conflict of interest in entering into a business transaction with his or her attorney; (2) The creditor-debtor relationship created a relationship between Trewin and his clients in which they had differing and competing interests—therefore he was in violation of SCR 20:1.7(b).
- Trewin: (1) Entering into lender-debtor or business relationships with clients without securing written, informed consent waivers was not required by SCR 20:1.8(a)—it is sufficient for the client to sign the loan documents and there is no need for a written waiver of any potential conflict of interest; (2) There is no evidence of the likelihood of the alleged possible adverse effects and such hypothetical risks were unlikely to occur —therefore there was no violation of SCR 20:1.7(b).

COURT'S RULING

Wisconsin Supreme Court Rule 20:1.8

- Trewin's argument that having the client sign the loan documents is all that is required would render the remainder of the rule superfluous
- The only interpretation that would give effect to all three subsections of this rule is that the client must give separate consent to the transaction with the lawyer, waiving the conflict of interest, and the client must indicate in writing he or she has been given a reasonable opportunity to consult with independent counsel
- Trewin violated SCR 20:1.8(a)—A separate written conflict waiver was required prior to Trewin entering into the business transactions with his clients

Wisconsin Supreme Court Rule 20:1.7

- Trewin violated SCR 20:1.7—he failed to advise his clients in writing of the possible adverse effects of entering into business relationships with them; the rule does not require any particular degree of likelihood that adverse effects will accrue by the attorney entering into business relationships with clients.

The court suspended Trewin's license for five months and assessed costs of the proceeding to Trewin.

Trewin entered into loan transactions with clients who were experiencing serious financial problems and thus were in a vulnerable position. There was sufficient evidence to support the conclusion that Trewin violated various Wisconsin Supreme Court Rules.

In re Chicago M. S. P. & P. R. Co.

840 F.2d 1308; 1988 U.S. App. LEXIS 2201; Bankr. L. Rep. (CCH) P72,210

FACTS

- This is an appeal by Attorney Rosenstein seeking reversal of the lower court judgment which denied Rosenstein his attorney fees for bankruptcy work
- Rosenstein is a bankruptcy attorney who became the president, sole director, and sole shareholder of a company (Stickney) whose purpose was to trade creditor claims against the debtor
- Stickney also retained Rosenstein as its attorney to obtain a higher rate of interest for the claims of trade creditors
- Stickney purchased $370,000 worth of trade creditor claims against Milwaukee Road (debtor) who filed for bankruptcy
- Rosenstein wanted his legal fees to be paid from Milwaukee Road's estate —the special master recommended that the district court deny Rosenstein's fee application

ISSUE

Whether a bankruptcy attorney purchasing, selling or trading claims against a debtor while acting in a representative capacity in the bankruptcy reorganization barred him from recovering fees from the debtor's estate

RELEVANT AUTHORITY

Bankruptcy Rule 8-212(c) Limitations on allowance

(2) Denial of allowance. No compensation or reimbursement shall be allowed to any committee, attorney, or other person acting in the case in a representative or fiduciary capacity who, at any time after assuming to act in such capacity has, without approval of the court, purchased or sold claims against, or stock of, the debtor or beneficial interests, direct or indirect, in such claims or stock, or by whom or for whose account such claims, stock or beneficial interests therein have been otherwise acquired or transferred.

ARGUMENTS

- Rosenstein: (1) The trial court erred in approving the special master's recommendation that the request for the payment of attorney's fees from the estate is barred under Bankruptcy Rule 8-212(c)(2); (2) He did not purchase claims against the debtor for his own benefit and thus did not have a conflict of interest within the meaning of Rule 8-212; (3) At no time was he ever placed in a position of representing conflicting positions, nor did he have access to any information not contained in the public records of the bankruptcy proceedings.

COURT'S RULING

Bankruptcy Rule 8-212(c) Limitations on allowance

- Rosenstein's purchase and sale of claims against the debtor during the time he represented Stickney and other trade creditors runs head first into the express terms of and purposes behind Rule 8-212(c)(2)
- Rosenstein purchased the claims of almost ninety trade creditors at a substantial discount, and sold many of the claims for profit without acquiring court approval
- Rule 8-212(c)(2) prevents Rosenstein from collecting fees from the estate— (1) Rosenstein was an attorney acting in the case in a representative capacity and has purchased and sold claims against the debtor; and (2) Rosenstein had a direct interest in Stickney's purchase of trade claims against the debtors
- Rosenstein's ownership interests in Stickney gave him a direct and substantial interest in every purchase or sale of trade creditor claims on behalf of Stickney that occurred during the bankruptcy proceedings
- There is no merit to Rosenstein's argument that his alleged lack of inside information or the absence of an actual conflict of interest should suspend the operation of Rule 8-212(c)(2)

COURT'S RULING (cont'd)

- Both his intimate knowledge of the proceedings as well as his status as the attorney of record enabled him to obtain superior knowledge both about the likelihood and the timing of payments on trade creditor claims, thereby benefitting the business of the Stickney Corporation, whose sole purpose was to speculate on those claims—Rosenstein's access to this kind of information placed him in a strategic position.
- The court declined to create an exception to Rule 8-212(c)(2) for Rosenstein. The court held that Rosenstein's purchase and sale of claims against the debtor while he acted in a representative capacity in the bankruptcy reorganization bars him from recovering fees from the estate.

In re Spencer
355 Or. 679, 330 P.3d 538 (2014)

FACTS

- Lawyer disciplinary proceeding—Oregon State Bar charged a lawyer with violating two Rules of Professional Conduct: RPC 1.7(a) and RPC 1.8(a)
- Lawyer met with prospective client, Smith-Canfield (S-C), to discuss the client filing for bankruptcy
- S-C owned out-of-state property and the lawyer advised her to take advantage of an exemption in bankruptcy law by selling that property and moving into a new home within one year of that sale
- While preparing for the bankruptcy filing, the lawyer also served as S-C's real estate broker to find a new property for S-C that fits her needs
- The lawyer, in his role as S-C's real estate broker, advised S-C not to get a professional inspection done on the new property
- S-C, after seeking independent counsel, terminated the lawyer's representation of her as her broker and lawyer

ISSUE

Whether an attorney acting as a bankruptcy client's real estate broker is considered a "business transaction" in which the attorney "knowingly acquired a pecuniary interest adverse to" the client

RELEVANT AUTHORITY

Oregon Rules of Professional Conduct 1.8

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire a pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;

(2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and

(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction

Oregon Rules of Professional Conduct 1.7

(a) A lawyer shall not represent a client if the representation involved a current conflict of interest. A current conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client;

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer; or

(3) the lawyer is related to another lawyer, as parent, child, sibling, spouse or domestic partner, in a matter adverse to a person whom the lawyer knows is represented by the other lawyer in the same matter

ARGUMENTS

Lawyer: (1) When he agreed to act as S-C's real estate broker, he was not entering into a "business transaction"—an agreement to serve as a real estate broker is no different from an agreement to serve as a lawyer; (2) the prospect of receiving a commission if the real estate sale closed did not create a conflict of interest any more than the prospect of receiving a contingency fee; and (3) His agreement with S-C to serve as her real estate broker and to represent her in the bankruptcy proceeding was different parts of the same transaction

Bar: (1) The lawyer's personal financial interest in obtaining a share of the real estate commission presented a significant risk of materially limiting his legal representation of S-C; and (2) A 2006 Oregon State Bar ethics opinion supports the position that the prospect of recovering a real estate commission will always create a conflict of interest; and (3) the problems that S-C experienced subsequent to the purchase of the new home demonstrates that the lawyer put his own interest in obtaining a sales commission ahead of his obligation to protect his client's interests

COURT'S RULING

- The lawyer violated Rule 1.8(a)—the lawyer entered into a business transaction with S-C without advising her to seek independent legal advice and giving her reasonable opportunity to do so, and without obtaining written consent; this rule violation caused potential and actual injury to S-C and put the lawyer in an advantageous position
- The lawyer did not violate Rule 1.7(a)—the record does not provide persuasive support for the Bar's argument that the problems that followed S-C's purchase of her home stemmed from the lawyer's interest in recovering a share of the sales commission (it was not materially limiting)
- Sanction for violating Rule 1.8(a)—30-day suspension from practicing law

PGH Int'l v. Gabor Shoes AG (In re PGH Int'l)
222 B.R. 401 (Bankr. D. Conn. 1998)

FACTS

- This is an action by Plaintiffs-Debtors to disqualify a law firm (Rogers & Wells) from representing a Defendant-Creditor in an adversary proceeding
- At one time, the defendant was the sole stockholder of the plaintiff—it eventually sold its entire stock interest
- When the defendant was the sole stockholder of the plaintiff, defendant was represented by certain attorneys, who are now part of Rogers & Wells, in various legal matters
- Rogers & Wells also represented the debtor in securing a loan and security agreement that is subject to the bankruptcy litigation
- Rogers & Wells is an unsecured creditor of the plaintiffs-debtors for unpaid legal fees arising from services unrelated to the transactions at issue in the present adversary proceeding
- The defendant-creditor has fully consented to Rogers & Wells continuing to act as its counsel in this adversary proceeding while at the same time asserting rights as an unsecured creditor in the debtors' bankruptcy cases

ISSUE

Whether a law firm can represent a creditor in a bankruptcy adversary proceeding when that same law firm (1) is itself an unsecured creditor in the proceeding and (2) previously represented the debtor in negotiating a loan that is subject to the proceeding

RELEVANT AUTHORITY

Local District Court Rule 33
(a) Refusing Employment When Counsel May be Called as a Witness: A lawyer shall not accept employment in contemplated or pending litigation if he or she knows or it is obvious that he or she or a lawyer in the same firm ought to be called as a witness, except . . . :
(1) if the testimony will relate solely to an uncontested matter;
(2) if the testimony will relate solely to a matter of formality and there is no reason to believe that substantial evidence will be offered in opposition to the testimony; and
(3) if the testimony will relate solely to the nature and value of the legal services rendered in the case by the lawyer or the law firm of the client.

Connecticut Rules of Professional Conduct 1.7
(b) A lawyer shall not represent a client if the representation of that client may be materially limited . . . by the lawyer's own interests, unless:
(1) The lawyer reasonably believes the representation will not be adversely affected; and
(2) The client consents after consultation.

Connecticut Rules of Professional Conduct 1.9
(b) A lawyer who has formerly represented a client in a matter shall not thereafter:
(1) Represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client consents after consultation; or
(2) Use information relating to the representation to the disadvantage of the former client except as Rule 1.6 would permit with respect to a client or when the information has become generally known.

ARGUMENTS

- Plaintiffs-Debtors: (1) Counsel as Witness—Rogers & Wells lawyers are likely to be called as witnesses in the adversary proceeding; (2) Adverse Interest—Rogers & Wells representation of the defendant-creditor may be materially limited by its own interests because of its status as a creditor, therefore standing to benefit monetarily if plaintiffs prevail in the adversary proceeding; and (3) Prior Representation of the Debtors—Rogers & Wells prior representation of the debtors, in connection with securing a loan, compels disqualification
- Defendant-Creditor: (1) Counsel as Witness—the prospect of Rogers & Wells lawyers being called as material witnesses is slight; (2) Adverse Interest—Rogers & Wells reasonably believes its representation will not be adversely affected by its status as a general unsecured creditor of the debtor and that the defendant consented to this representation; and (3) Prior Representation of the Debtors—at the time the debtors were represented by Rogers & Wells, they had no legitimate expectation of confidentiality vis-à-vis their corporate parent (the present defendant)

COURT'S RULING

- Local District Court Rule 33 is not violated—the prospect of Rogers & Wells lawyers being called as material witnesses is slight; so, the law firm shouldn't be dismissed on this basis
- Connecticut Rule of Professional Conduct 1.7(b) is not violated—the technical conflict presented by Rogers & Wells' status as a creditor does not call into question the fair or efficient administration of justice, particularly where informed consent has been given; so, the law firm should not be dismissed on this basis
- Connecticut Rule of Professional Conduct 1.9 is violated—there is a substantial relationship between the prior representation of the debtor-plaintiffs and the current representation of the defendant; so, the law firm should be dismissed on this basis
- The court granted the debtor's motion to disqualify the law firm in this adversary proceeding

In re Sauer

191 B.R. 402 (Bankr. D. Neb. 1995)

FACTS

- This is a proceeding to determine whether a trust agreement between between an attorney and her debtor should be approved
- Pruss was retained by James Sauer and his company J.A.S. Enterprises (debtors) to represent both entities in Chapter 11 proceedings
- Household, a creditor, foreclosed on Sauer's home after his failure to make scheduled payments--without the court's approval, Pruss decided to purchase the home with the intention to hold the house for the benefit of Sauer as long as he makes the monthly mortgage payments (no trust agreement was executed)
- Pruss made this purchase through loans and from $43,345.21 advanced by Sauer
- The Stocks, who hold claims in the J.A.S. Enterprises proceeding, object to a proposed trust arrangement between Pruss and Sauer—they believe Sauer took the $43,345.21 from the J.A.S. Enterprises estate to help purchase the residence

ISSUE

Whether a debtor's attorney can purchase former property of the debtor's bankruptcy estate and continue to serve as debtor's counsel without violating conflict of interest laws

RELEVANT AUTHORITY

11 U.S.C. § 327

(a) 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 to represent or assist the trustee in carrying out the trustee's duties under this title

(c) In a case under chapter 7 or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, but may not, while employed by the trustee, represent, in connection with the case, a creditor

11 U.S.C. § 101

(14) "disinterested person" means a person that –

(A) is not a creditor, an equity security holder, or an insider;

(E) 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

Nebraska Disciplinary Rule 5-103: A lawyer is prohibited from acquiring a proprietary interest in the subject matter of litigation she is conducting for a client, or from advancing financial assistance to her client

Nebraska Disciplinary Rule 5-104: A lawyer is to limit business relations with a client and is prohibited from entering into a business transaction with a client where the attorney and client have differing interests

Nebraska Disciplinary Rule 5-105: A lawyer must withdraw from employment if the exercise of independent professional judgment on behalf of a client is or will likely be impaired

Nebraska Disciplinary Rule 7-102(A)(8): A lawyer is prohibited from knowingly engaging in illegal conduct or conduct that is contrary to a Disciplinary Rule

Nebraska Disciplinary Rule 6-102: A lawyer is prohibited from attempting to exonerate herself or limit her liability to a client for personal malpractice

Nebraska Canon 9: A lawyer is to avoid even the appearance of impropriety

ARGUMENTS

- Pruss: (1) She did not violate any ethical prohibition, since she purchased the residence after the trust deed was foreclosed, so that at the time of her purchase of the home, it was not property of the bankruptcy estate, and that there was no plan to purchase or agreement to do so prior to the time of the trust deed sale; (2) She purchased the residence from the lender, and not directly from the estate, in an arm's length transaction; and (3) If the court does not approve the trust agreement, Pruss will use the $43,335.21 as payment of attorney fees
- Stocks: The trust agreement should not be approved because (1) a conflict of interest will be created because Pruss will become both the representative of the estates and a creditor of the James Sauer estate; (2) Pruss will hold an interest adverse to the bankruptcy estates, and will no longer be disinterested; (3) the transaction cannot be considered an arm's length transaction because of the prior relationship of the attorney and client; (3) full disclosure should be made—anything short of full disclosure is a criminal violation; and (4) it was improper to use bankruptcy estate funds from the J.A.S. Enterprises or James Sauer bankruptcy estates for the purchase of the residence

COURT'S RULING

- Pruss's purchase violates Nebraska Code of Professional Responsibility
- Canon 9 is violated—Pruss's purchase of the residence, a former asset of the bankruptcy estate, still resulted in her ownership of an asset in which her client Sauer, individually, holds an interest, and her bankruptcy estate clients *may* hold an interest; this raises an appearance of impropriety
- DRs 5-103 and 5-105 are violated—Pruss, while acting as attorney for the debtor in possession and Mr. Sauer personally, has acquired a proprietary interest in an asset which was the subject of a trust deed proceeding, an eviction proceeding, and the subject of disputes which should have been expected to arise in the bankruptcy case; at minimum, this creates an appearance of impropriety
- Pruss should not represent Sauer in his individual capacity as they have conflicting financial interests in the home and have conflicting economic interests respecting various issues pending and anticipated to be pending in the bankruptcy case
- Pruss may not elect to treat the $43,335.21 as payment for attorney fees

Wagner Choi & Evers v. Woo (In re WorldPoint Interactive, Inc.)
2005 Bankr. LEXIS 3378 (U.S. B.A.P. 9th Cir. June 28, 2005)

FACTS

- The State of Hawaii made a loan to WorldPoint (debtor); after non-payment, Hawaii filed a collection action against debtor in Hawaii state court
- Debtor consulted with law firm WCE regarding the collection action—to secure payment of fees, debtor provided a security interest to WCE
- A WCE attorney presented documents to Fuchs, a director of the debtor, which created a blanket security interest in favor of WCE in debtor's assets
- The agreement was executed even though the attorney failed to advise Fuchs or the debtor to seek independent counsel and failed to give Fuchs the opportunity to consult counsel before executing the agreement
- After an involuntary bankruptcy petition was filed against the debtor, Hawaii state court held that WCE had a valid enforceable security interest
- WCE filed a secured claim against the debtor; the Trustee objected to this claim arguing WCE committed malpractice and violated professional ethics

ISSUE

Whether a debtor's former law firm, who represented the debtor in a collection action, can create a blanket security interest in favor of the firm in the debtor's assets without violating Hawaii's Rules of Professional Conduct

RELEVANT AUTHORITY

Hawaii Rules of Professional Conduct 1.8

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which can be reasonably understood by the client;

(2) the client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and

(3) the client consents in writing thereto.

(i) A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:

(1) acquire a lien authorized by law to secure the lawyer's fee or expenses; and

(2) contract with a client for a reasonable contingent fee in a civil case.

ARGUMENTS

- WCE: (1) the bankruptcy court erred as a matter of fact in concluding that debtor was not given a sufficient opportunity to consult independent counsel; (2) the bankruptcy court erred as a matter of law, alleging Rule 1.8(a) was inapplicable because its transactions with debtor are actually covered by Rule 1.8(I) which deals with acquiring a lien on the subject matter
- Trustee: (1) WCE is not entitled to their claim because the transaction by which the firm obtained its security interest violated the Hawaii Rules of Professional Conduct, particularly the rule requiring a lawyer to give his or her client a reasonable opportunity to seek the advice of independent counsel before entering a business transaction in which the lawyer acquires a security interest adverse to the client

COURT'S RULING

- The security documents were drafted the same day they were presented to Fuchs and signed—this time period did not give the debtor a reasonable opportunity to seek independent counsel
- Rule 1.8(a) applies in this case—Rule 1.8(I) only applies in cases where the liens are "granted" by law; here, the lien acquired by WCE was not "granted" by law
- Here, the debtor had the assets before the security agreements with WCE were executed—WCE's efforts did not result in a recovery of those assets for debtor, and its lien thus falls outside the scope of subsection Rule 1.8(j)
- The court affirmed the bankruptcy court in invalidating WCE's security interest for violating Rule 1.8(a)

In re Schwindt,

2013 Bankr. LEXIS 342, 2013 WL 321297
(Bankr. D. Colo. Jan. 28, 2013)

FACTS

- The Schwindts ("Debtors") were the sole owners and managers of a Colorado limited liability company, Eastridge Transportation, LLC. Eastridge's principal business was trucking. Each of the Schwindts held an equal fifty percent ownership interest in Eastridge, and they derived all income from their employment with Eastridge.
- From 2008 to 2009, a bank made three loans to Eastridge, each of which was cross-collateralized and personally guaranteed by the Schwindts.
- Following the closure of the bank, the three loans were sold to LNV Corp. After the negotiations failed with LNV, on June 11, 2012, Eastridge filed for relief under Chapter 11 of the Bankruptcy Code.
- On June 13, 2012, the Court entered an order approving Kutner, Miller, Brinen, P.C. ("KMB") as general counsel for Eastridge.
- In August 2012, LNV filed a lawsuit against the Schwindts, seeking recovery on the personal guarantees. On October 16, 2012, the Schwindts filed their voluntary petition for relief under Chapter 11.
- The Schwindts asked the Court for permission to employ the same firm that was representing Eastridge, and the United States Trustee filed an objection, claiming that the firm had a conflict of interest.

Relevant Authority :

Section 327(a) of the Bankruptcy Code states in pertinent part:

(a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

Section 327(c) provides as follows:

(c) In a case under chapter 7, 12, or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.

Arguments

- The United States Trustee filed the objection to KMB's employment as the Schwindts' counsel, alleging that KMB had an actual conflict of interest with the Debtors' bankruptcy estate and therefore was unable to satisfy the requirements of § 327(a) of the Bankruptcy Code.
- The United States Trustee contended that Schwindts had unsecured debts which were not joint obligations of Eastridge and therefore the characterization of the $51,867.91 as a loan or an owner contribution to Eastridge created competition between the two estates to see which one will benefit at the expense of the other.

Court's Ruling

- The Court granted the Debtors' application.
- The Court found that although the Debtors had made cash advances to their company, they did not have an actual conflict of interest with their company because they were not creditors of their company and had common interests with their company.
- The Court held that the fact that there might be potential for a conflict of interest was not enough to deny the application.
- The Court found that neither of the Schwindts were creditors of the Eastridge estate, and there was no indication the two estates were pursuing causes of action against each other. The Court stated that there was no competition between the interests of the two estates, and therefore, KBM did not held or represent any interest adverse to the estate.
- The Court concluded the Schwindts' employment of KMB as general counsel under § 327(a) was proper and the threshold requirements of § 327(a) were satisfied.

Court's Ruling

- The Court also stated that §327(c) exception to the general rule under §327(a) only applies when a professional seeking employment as counsel for a trustee or debtor-in-possession also represents a creditor of the estate.
- In the case at bar, the Court held that because KMB was not seeking dual representation of a debtor and a creditor of the estate, the exception under § 327(c) was not applicable to the instant matter
- The Court granted the Debtors' application to employ KMB as its counsel, but stated that fees and costs charged by the firm were subject to allowance or review by the Court in accordance with 11 U.S.C.S. §§ 329, 330 and 331.

Conclusion

- Multi-debtor representation under 11 U.S.C.S. § 327(a) is determined on a case-by-case basis, and rather than disapproving of multi-debtor representation as a per se conflict, courts should examine the factual circumstances surrounding the representation to determine whether it is appropriate.
- Section 327(a) does not mandate disqualifying counsel for any potential conflicts.

In re Weilert,

2016 Bankr. LEXIS 4235 (Bankr. E.D. Cal. Dec. 8, 2016)

Facts

- Debtor Gregory and Parker, Inc. owned and operated commercial properties in Raleigh, North Carolina.
- Debtor filed its chapter 11 petition on February 22, 2012, with Richard D. Sparkman and Richard D. Sparkman & Associates, P.A. serving as counsel.
- Debtor was owned by an individual and his wife William Douglas Parker, Jr. and his wife, Diana Lynne Parker (the "Parkers")
- The Parkers also filed a chapter 11 petition, with William P. Janvier and Janvier Law Firm, PLLC (" Janvier") serving as counsel.
- The Debtor and the Parkers had a common creditor, i.e. Defendant Conan R. McClain, who had provided professional services related to redevelopment, financing, marketing, leasing and management of the Debtor's commercial properties.
- The Debtor sought to have Janvier law firm jointly represent the Debtor and the Parkers for purpose of an adversary proceeding against the Defendant McClain.
- The Defendant objected.

Arguments

- The Defendant objected to joint representation, alleging that certain conflicts of interest existed between the Debtor and the Parkers, the individual debtors.
- The Debtor argued that the Debtor and Parkers anticipated joining as plaintiffs to file an adversary proceeding against Mr. McClain, alleging certain misconduct of McClain. The Debtor acknowledged that although Janvier had not previously represented the Debtor, but contended that because of its extensive knowledge of the relevant facts, joint representation of the Debtor and the Parkers in the adversary proceeding would be most economical, and based on the specific, limited scope of engagement, and did not create a conflict of interest.

Relevant Authority :

Section 327 of the Bankruptcy Code states in pertinent part:

(a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

(e) The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, 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.

Court's Ruling

- The Court acknowledged that representation as general counsel of a corporate debtor and its principal(s) in two bankruptcy proceedings creates a conflict of interest. However, the Court stated that the case at bar involves employment of an attorney as counsel for the limited purpose of representation in an adversary proceeding.
- The Court stated that Sparkman, as the Debtor's general counsel in the overall bankruptcy case, must represent and assist the Debtor in carrying out its fiduciary duties as Debtor-in-possession. Accordingly, Sparkman, not Janvier, had a duty to bring any potential avoidance actions against the Parkers, or to object to the Parkers claim against the Debtor, if such actions were warranted. Finally, consistent with upholding these fiduciary duties, Mr. Sparkman must monitor the adversary proceeding brought by the Debtor against McClain to ensure that the bankruptcy estate's interests were zealously represented by Janvier.
- The court stated that Janvier's representation of the Debtor in a proceeding against the Defendant McClain had no effect on Sparkman's independent duties and abilities to appropriately represent the Debtor-in-possession and the bankruptcy estate. Thus, the court found that there was no actual conflict of interest that would disqualify Janvier under § 327(c) from representing the Debtor in the proceeding against McClain.

- The Court stated that under the two requirements of 11 U.S.C.S. § 327(a), counsel was a disinterested person as defined by 11 U.S.C.S. § 101(14)(C) and he did not hold or represent any interest adverse to the estate. The interests of all the Debtors were aligned with respect to the adversary proceeding.
- The Court granted the Debtor's application to employ the attorney and his firm as counsel in the adversary proceeding.

CONCLUSION

While the policy of 11 U.S.C.S. § 327(a) requires a professional to give undivided loyalty to the client, this requirement may be waived in appropriate cases if the parties in interest so desire.

In re First State Bancorporation, No. 7-11-11916 JA, 2013

Bankr. LEXIS 873 (U.S. Bankr. D.N.M. Mar. 6, 2013)

FACTS

- The Debtor, First State Bancorporation, in this Chapter 7 proceeding was a bank holding company. The Bank was a wholly-owned subsidiary of the Debtor.
- There were only three creditors of the Debtor, one being an insignificant state claim for taxes. The only other creditors were 1) Wilmington Trust Company (WTC) in its capacity as indenture trustee in the bankruptcy case, an unsecured creditor, and 2) Federal Deposit Insurance Corporation, as receiver of the Bank.
- The Trustee of Debtor sought to hire law firm Alston & Bird (A&B) as special counsel to assert a fraudulent transfer claim against FDIC.
- A&B filed a disclosure disclosing that 1) it represented WTC "in its capacity as indenture trustee for certain trusts that issued junior subordinated debt securities to certain holders"; 2) WTC was a creditor of the Debtor's bankruptcy estate; and 3) A&B also represented WTC in matters unrelated to this Chapter 7 bankruptcy case.

Arguments

- FDIC objected to the trustee's application for retention of A&B as special counsel as A&B represented WTC in preparation of proof of claim in the amount exceeding $100 million and other related matters. Therefore, it contended that a conflict of interest would arise if A&B was appointed as special counsel for the Debtor.
- The Trustee contended that the interests of WTC and the trustee were perfectly aligned with respect to the Trustee's assertion of a fraudulent transfer claim against FDIC and with respect to the claim to recover the Tax Refund for the estate, and, therefore, A&B had no conflict of interest in representing both A&B and the Trustee in these matters.

Relevant Authority :

Section 327(a) of the Bankruptcy Code:

(a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

Section 327(c) of the Bankruptcy Code:

(c) In a case under chapter 7, 12, or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.

Court's Ruling

- WTC held an interest that was adverse to the bankruptcy estate at that time, therefore, an actual conflict existed that disqualified A&B from representing the trustee as special counsel.
- The law firm's simultaneous representation of WTC and the Chapter 7 Trustee would interfere with the Chapter 7 Trustee's obligation to administer the bankruptcy estate impartially, taking into account the interests of all creditors of the estate.

Conclusion

- A proposed counsel to be hired by a Chapter 7 Trustee must not hold or represent an interest adverse to the estate and the attorney must be disinterested. If either of the two requirements is not met, there may be a conflict of interest.

Shapiro v. French (In re Connolly N. Am., LLC), No. 09-14179, 2010

U.S. Dist. LEXIS 123368 (E.D. Mich. Nov. 22, 2010)

FACTS

- In November, 2001, Mark H. Shapiro was appointed as Chapter 7 trustee for the estate of Debtor Connolly North America, LLC.
- On July 17, 2009, creditors Mediofactoring, Coface Argentina, and Curtiembre Arlei, S.A. filed a motion for the removal of Shapiro as trustee.

ARGUMENTS

- The creditors' effort to remove Shapiro as trustee was premised upon his failure to investigate and prosecute certain claims on behalf of the bankruptcy estate, and his conflict of interest in investigating and pursuing these claims against himself and his law firm.
- These claims included

  - a claim arising from Shapiro's "gross negligence" in the course of an accounting malpractice adversary proceeding brought by Shapiro.

  - claims arising from Shapiro's failure to investigate and pursue the recovery of approximately $20 million in potentially avoidable insider transfers.

- In a hearing in September, 2009, the creditors mentioned two more claims where Shapiro allegedly had conflict of interest:

  - claims arising from Shapiro's failure to timely bring a preference claim against one of the debtor's creditor before the statute of limitations `ran on this claim; and

  -claims arising from the dismissal of an adversary proceeding against one of the debtor's creditor due to alleged mistakes made by Shapiro and his counsel at trial.

- Shapiro principally contended that most of the potential claims against him and his firm that the Bankruptcy Court cited in its ruling were barred by the applicable statutes of limitation, so that there was no need to investigate them.

11 U.S. Code § 324 - Removal of trustee or examiner

(a) The court, after notice and a hearing, may remove a trustee, other than the United States trustee, or an examiner, for cause.

Court's Ruling

- Although Section 324 (a) does not define the term "cause" based on which the court may decide regarding removal of a trustee, a "conflict of interest" if shown with specific facts may be a sufficient cause that the court may consider in deciding removal of trustee from the bankruptcy case.
- Trustee's duty to disclose potential conflict is continuing during the bankruptcy case.

Conclusion

- A proposed counsel to be hired by a Chapter 7 Trustee must not hold or represent an interest adverse to the estate and the attorney must be disinterested. If either of the two requirements is not met, there may be a conflict of interest.

In re Roper & Twardowsky, LLC,

No. 15-32878 (SLM), 2017 Bankr. LEXIS 537 (U.S. Bankr. D.N.J. Feb. 24, 2017)

FACTS

- Angela Roper and Kenneth Thyne were equity holders and principals of the Debtor Roper and Twardowsky, LLC.
- The Debtor's case involved disputes over respective rights to settlement proceeds between the Debtor and a number of law firms and lawyers that served as the Debtor's co-counsel in a pre-petition litigation.
- During the pre-petition litigation, the Debtor entered into various agreements with other law firms and attorneys, including but not limited to Bendit, Bochetto, Gorman & Gorman LLC ("Gorman"), Skepnek and Smoot and Goldman Davis & Gutfleish, P.C. ("Goldman").
- A settlement was reached with Gorman and Goldman, so they were not active in this bankruptcy case. However, Bendit, Bochetto and Skepnek and Smoot were creditor
- The settlement funds were placed in the Roper and Twardowsky Qualified Settlement Fund ("QSF"). Ms. Roper, was assigned to serve as the QSF Trustee. Shortly after the QSF beneficiaries received their settlement payments.

- The Plaintiff filed an application to retain Roper and Thyne, LLC as special counsel to perform litigation services necessary during the claims objections, including appearing on behalf of the Trustee at hearings, discovery and oral argument. Specifically, the Trustee seeks to employ Roper & Thyne in connection with the resolution of the claims of three creditors in the Debtor's bankruptcy case i.e. 1) Bochetto 2)Bendit; and 3) Skepnek and Smoot.
- The three creditors objected to Trustee's application to retain Roper and Thyne as special counsel.

<u>Arguments</u>

- The trustee contended that employment of Roper and Thyne, LLC as special counsel would lower administrative costs dramatically and provide "an invaluable service to the estate.
- According to the trustee, Roper and Thyne were already well aware of the pre-petition litigation and the creditors' claims unlike the trustee who would have to study the case from scratch that would potentially increasing estate's cost.
- In respect to potential conflicts of interest, the trustee contended that Roper & Thyne's interest in the claim objections were the same interests as the bankruptcy estate.
- Among other objections related to the mandatory requirements for employment of a special counsel, the creditors argued that Roper and Thyne held too many interests in this bankruptcy. Therefore, it would be impossible for Roper and Thyne to provide impartial, neutral advice to the Trustee in connection with the claims litigation.
- The Objecting Creditors maintained that retention of Roper & Thyne would violate New Jersey Rules of Professional Conduct 1.7(a) and 3.7. and Section 327(e) due to the conflicts of interests.

Relevant Authority :

Section 327 of the Bankruptcy Code states in pertinent part:

(a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

(e) The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, 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.

Court's Ruling

- The court found that the principals of Roper & Thyne were current creditors of the estate and undoubtedly held an economic interest that would lessen the value of the bankruptcy estate.
- The court also found that Ms. Roper held a $25,000,000 claim against the estate, which was by far the largest filed claim in the case.
- The court opined that of Roper & Thyne were retained to litigate the Trustee's Objection to Bendit's Claim, they would represent the estate in the main bankruptcy proceeding — the same bankruptcy proceeding where Ms. Roper and Mr. Thyne held pre-petition claims against the estate.
- According to the court, this was a blatant example of representing parties on opposite sides of a litigation, which was prohibited under New Jersey Rules of Professional Conduct and Section327(e) of the code.
- The court denied the trustee's application to retain Roper and Thyne as special counsel.

Conclusion

- In the Third Circuit, there is a bar to the appointment of a law firm with an actual conflict of interest. A conflict is deemed actual, and per se disqualifying, if it is likely that a professional will be placed in a position permitting it to favor one interest over an impermissibly conflicting interest.
- Professionals with a potential conflict of interest may not be approved for employment.

In re Licking River Mining, LLC,

No. 14-10201 Jointly Administered, 2015 Bankr. LEXIS 3194
(U.S. Bankr. E.D. Ky. Sep. 22, 2015)

FACTS

- In the Debtors Licking River Mining, LLC et al.'s bankruptcy case, the Trustee Phaedra Spradlin filed applications to employ the following:
  - Barber Law PLLC, as general and litigation counsel
  - Foley and Landner LLP, as Committee Litigation counsel in an adversary proceeding against Debtors' largest secured creditors, East Coast Miner LLC, East Coast Miner II LLC, Keith Goggin and Michael Goodwin (collectively the "Lenders")
  - Bingham Greenbaum Doll (BGD), as special counsel in the bankruptcy case.
- The U.S. Trustee ("UST") and Lenders filed objections to employment of Barber's and Foley's employment.
- The Lenders also objected to the employment of BGD as special counsel.

Arguments

- The UST contended that Barber and Foley's pending final chapter 11 Committee counsel fee applications requested immediate payment of their allowed fees from a court-approved carve-out from the Lenders' collateral.
- The UST argued that because the Committee Litigation pending against the Lenders sought, in part, to avoid the Lenders' liens, Barber's and Foley's request for immediate payment from the carve-out directly conflicted with the bankruptcy estates' position that the liens were invalid.
- According to the UST, the conflict arose because if the liens were invalid, the carve-out was invalid; and potentially, Barber and Foley would have been required to disgorge any payments they receive from the carve-out.
- The Lenders also filed objections to Barber's and Foley's employment on similar grounds and further asserted that through their administrative claims for chapter 11 professional fees, Barber and Foley held interests adverse to the estates and materially adverse to other creditor classes.
- Additionally, the lenders objected to the employment of BGD arguing that BGD's proposed services were not for a "specified special purpose" but rather that it was being employed to "conduct the cases" which would require BGD to be employed under § 327(a)

Relevant Authority :

Section 327 of the Bankruptcy Code states in pertinent part:

(a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

(e) The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, 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.

Court's Ruling

- The court observed that subsumed in the Lenders' argument was the notion that if their liens were avoided, the carve-out was likewise invalid. The court held that the Lenders cited no authority for this position, and the impact of such action on the carve-out is far from clear.
- The court held that such a potential conflict was too remote and speculative to prevent Barber's or Foley's employment.
- Further, in the event issues of the carve-out's validity and/or disgorgement were raised, one of BGD's proposed duties was to serve as the Trustee's counsel with sole responsibility to review and, if necessary, litigate carve-out related issues. This adequately alleviated any remote potential that Barber or Foley would be poised to bring an action for disgorgement against themselves.
- The Court found that neither Barber nor Foley had an interest materially adverse to the estates or to any class of creditors. Therefore, they were disinterested within the meaning of § 101(14)(C) and met the requirements for employment under § 327(a).

- As to BGD's employment application, the court held that the fact that the Trustee had not yet determined what actions should be pursued against a specific list of parties did not make BGD's employment as litigation counsel any less a special purpose. Further, its services as counsel on issues related to, and limited to, the carve-out, coal industry and environmental matters were likewise specified special purposes.
- Therefore, the court granted Trustee's applications to employ the 3 law firms for purposes specified in her applications.

Conclusion

- If it is plausible that the representation of another interest may cause a debtor's attorneys to act any differently than they would without that other representation, then they have a conflict and an interest adverse to the debtor's estate.
- An actual conflict exists if there is an active competition between two interests, in which one interest can only be served at the expense of the other.
- Interests are not considered "adverse" merely because it is possible to conceive a set of circumstances under which they might clash.