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Prevent Disqualification and Disgorgement: Disclosure Is Key

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Disqualification and disgorgement are the potential consequences for counsel in chapter 11 cases who fail to disclose connections when being employed.[1] These remedies are harsh because each and every bankruptcy case implicates, in some measure, the public interest in the fair and open process that constitutes a federal court-supervised reorganization or liquidation. Therefore, it is incumbent upon counsel to properly disclose all connections at the inception of a case, supplement disclosure thereafter, and avoid disqualifying conflicts of interest. When an attorney fails to meet his/her disclosure obligations, courts then engage in the difficult exercise of balancing the interests of the client in choosing its counsel freely against disqualification, and the requirement for disgorgement of fees, with the equitable interests of the attorney who provided valuable services in representing that client.

The Disclosure Obligations of Fed. R. Bankr. P. 2014(a)

Section 327(a) sets forth the initial requirement that counsel in a bankruptcy case be free from disqualifying conflicts of interest. Counsel must be "disinterested" and hold no "interest adverse to the estate."[2] To ensure that this baseline standard for approval of employment is maintained, Fed. R. Bankr. P. 2014(a) requires disclosure, by a verified statement of the attorney applicant, of "all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States [T]rustee, or any person employed in the office of the United States [T]rustee," to the best of the applicant's knowledge.[3] Thus, Fed. R. Bankr. P. 2014 "[assists] the court in ensuring that [a professional] has no conflicts of interest and is disinterested, as required by 11 U.S.C. § 327(a)."[4]

"The disclosure requirements of [Fed. R. Bankr. P.] 2014(a) are broader than the rules governing disqualification, and an applicant must disclose all connections regardless of whether they are sufficient to rise to the level of a disqualifying interest under Section 327(a)."[5] The completeness of disclosure is viewed strictly,[6] although there is some disagreement among the courts as to what constitutes adequate disclosure.[7] Moreover, it is insufficient to make full disclosure of counsel's connections as they exist at the inception of the case. The disclosure obligation continues throughout the case.[8]

1 While state bar rules of professional conduct are the basis for determining whether underlying conflicts of interest rise to the level of actual ethical violations, this article is not intended to address individual state bar standards and procedures for disciplining attorneys who violate such rules.

2 11 U.S.C. § 327(a) (2014).

3 Fed. R. Bankr. P. 2014(a).

4 *In re Fresh Choice LLC*, No. 12-46157, 2014 WL 929018, at *5 (Bankr. N.D. Cal. March 10, 2014) (citing and quoting *Neben & Starrett Inc. v. Chartwell Fin. Corp. (In re Park-Helena Corp.)*, 63 F.3d 877, 881 (9th Cir. 1995)).

5 *In re Am. Int'l Refinery Inc.*, 676 F.3d 455, 465 (5th Cir. 2012).

6 *See, e.g., In re Fresh Choice LLC*, No. 12-46157, 2014 WL 929018, at *5 (Bankr. N.D. Cal. March 10, 2014) (citing and quoting *In re Park-Helena Corp.*, 63 F.3d at 881-82 ("The disclosure requirements of [Fed. R. Bankr. P.] 2014 are construed strictly, and 'failure to comply ... is a sanctionable violation, even if proper disclosure would have shown … the attorney had not actually violated any Bankruptcy Code provision or any Bankruptcy Rule.'").

7 *Compare In re Woodcraft Studios Inc.*, 464 B.R. 1, 8 (N.D. Cal. 2011) (stating that duty is one of complete disclosure of all known pertinent facts and professional has no discretion to withhold information), and *In re Park-Helena Corp.*, 63 F.3d at 882 (counsel may not pick and choose what connections are irrelevant or trivial), *with In re Blue Ridge Limousine and Tour Serv. Inc.*, 2014 WL 4101595, 5 (Bankr. E.D. Va. Aug. 20, 2014) (citing and quoting *In re Fibermark Inc.*, 2006 WL 723495, at *11 (Bankr. D. Vt. 2006) ("[D]etermination of the sufficiency of the disclosures … should be made by balancing the plain language of [Fed. R. Bankr. P. 2014(a)'s] mandate [to] disclose 'all connections' … against the common-sense analysis of what connections are … pertinent to the ultimate question of disinterestedness, so that competent professionals do not find the requirements of representing parties in bankruptcy cases so burdensome as to deter them from doing so."), *and In re Tribeca Mkt. LLC*, 516 B.R. 254, 279 (S.D.N.Y. 2014) ("attorney need not disclose every past or remote connection with every party in interest.... Rather, an attorney need disclose only those connections [that are] 'presently or recently existing, whether they are of business or personal in nature, which could reasonably have an effect on the attorney's judgment in the case.'"). The issues regarding burdens of disclosure at the individual attorney level were previously addressed in an article on *KLG Gates LLP v. Brown*, 506 B.R. 177 (E.D.N.Y. 2014). *See* Joseph J. McMahon, Jr., "Naming Names After *Brown*: Is There an Obligation under Rule 2014(a) to Identify Attorneys Who Staff Unrelated Creditor Representations?," XXXIII *ABI Journal* 5, 42-43, 108, May 2014.

The overarching goal of the Fed. R. Bankr. P. 2014(a) disclosure requirement is "to ensure undivided loyalty to the estate and to preserve public confidence in the fairness of the bankruptcy system."[9] Thus, while the initial process of checking for conflicts and disclosure might seem burdensome, it is critical that complete disclosure at the inception be the aim of every practitioner so that cases do not become mired in costly litigation over counsel's qualification for retention and serious consequences for failure to disclose do not result. Since the bankruptcy court must make the determination at the outset as to whether any of the connections that were disclosed amount to an adverse interest that could disqualify the attorney,[10] it is not for the attorney to make the judgment for the court by failing to disclose pertinent connections in the first place.[11]

Disqualification: A Rare Remedy

Courts presented with requests for disqualification must balance difficult and competing interests. On the one hand, failure to comply with Fed. R. Bankr. P. 2014(a)'s disclosure requirements is enough to warrant disqualifying counsel from employment.[12] On the other hand, if disclosure requirements have not been met, many courts remain reluctant to disqualify counsel, even where an initial employment application might have been denied at the inception of a case had the disqualifying connection been disclosed.

Disqualification is considered a drastic remedy that "requires courts to avoid overly mechanical adherence to disciplinary canons at the expense of litigants' rights to freely choose their counsel."[13] Moreover, while Fed. R. Bankr. P. 2014(a) imposes a mandatory obligation to disclose connections and adverse interests, it does not create a mandatory rule of disqualification if it is violated.[14] Thus, disqualification is in the court's discretion.[15]

In deciding on a remedy for failure to disclose, the court must undertake a case-by-case analysis, ensuring that the inquiry balances the attorney's duty to maintain the highest ethical and professional standards against the client's free choice of counsel.[16] However, the very nature of the inquiry makes it difficult for counsel to predict when disqualification will be ordered.

Section 327(c) provides guidance on when disqualification might be mandatory: Where there is *an actual conflict of interest* coupled with an objection to the engagement by a creditor or the U.S. Trustee, "the court *shall disapprove* such employment."[17] The conflict of interest "must be a real one and not a hypothetical or fanciful one."[18] Applying this standard, the court in *In re Legacy Development SC Group LLC* denied a trustee's motion to disqualify attorneys who were representing co-defendants and related entities.[19] The trustee asserted that representation of the affiliated defendants by the same counsel was a direct conflict of interest because, among other reasons, the financial transaction at issue made one defendant a creditor of the other.[20] The court's inquiry focused on the terms of the limited liability company's operating agreements, under which the subordinate entity had granted broad operating authority to the manager, and the fact that there was no evidence that consent for the dual representation was actually lacking.[21] Thus, the trustee failed to establish an actual conflict of interest, as opposed to a hypothetical future conflict of interest, warranting denial of disqualification.[22]

> **[S]ome courts conclude that if a professional was disqualified from employment by virtue of a conflict of interest, or because the professional's employment is otherwise precluded under the provisions of § 327(a), then compensation must be denied and, if already paid, disgorged.**

Disqualification can be denied where the moving party delays seeking relief,[23] which occurred in *KLG Gates LLP v. Brown*. The court found that although Roy E. Brown knew of the alleged conflict, he delayed seeking disqualification for three years; disqualification after that delay would cause severe prejudice to the liquidating trust because the plan had been effective for nine months before Brown filed the motion.[24] The rationale is that the moving party waived its right to seek disqualification by his delay.[25] Moreover, disqualification may not be used as a litigation strategy to bludgeon the opposing party with asserted conflicts of interest.[26] Nevertheless, although delay may be a reason for a denial of disqualification, the "court retains a continuing supervisory power to revisit a professional person's qualifications for employment and to disqualify a professional whose representation otherwise fails to conform to the disinterestedness standard."[27]

The question then becomes, when should a court exercise its discretion to disqualify counsel? A representative example occurred in *In re Madera* when counsel not only failed to disclose his prior connections, but also failed to disclose that he was a creditor of the debtor.[28] Explaining the seriousness of the counsel's disclosure failures, the court stated:

> The duty of disclosure is a continuing one, yet during the six months [that counsel] carried the pre-petition

8 *In re Harris Agency LLC*, 451 B.R. 378, 391 (Bankr. E.D. Pa. 2011); *see also In re Fresh Choice LLC*, No. 12-46157, 2014 WL 929018, at *5 (quoting *In re Kobra Props.*, 406 B.R. 396, 402 (Bankr. E.D. Cal. 2009) ("[T]he risk of defective disclosure always lies with the discloser.").
9 *In re Sundance Self Storage-El Dorado LP*, 482 B.R. 613, 625 (Bankr. E.D. Cal. 2012).
10 *Id.* at 631.
11 *In re Park-Helena Corp.*, 63 F.3d at 882.
12 *In re Tribeca Mkt. LLC*, 516 B.R. at 278; *In re Crivello*, 134 F.3d 831, 839 (7th Cir. 1998) ("[A] bankruptcy court should punish a willful failure to disclose … connections required by Fed. R. Bankr. P. 2014 as severely as an attempt to put forth a fraud upon the court.").
13 *Vieira v. Heritage Funding LLC, et al. (In re Legacy Dev. SC Grp. LLC)*, 517 B.R. 604, 606 (Bankr. D.S.C. 2014) (citing and quoting *Shaffer v. Farm Fresh Inc.*, 966 F.2d 142, 145-46 (4th Cir. 1992)).
14 *In re Persaud*, 496 B.R. 667, 676 (E.D.N.Y. 2013).
15 *Id.*
16 *In re Legacy Dev. SC Grp. LLC*, 517 B.R. at 606 (citations and quotations omitted).
17 11 U.S.C. § 327(c) (2014) (emphasis added).
18 *In re Legacy Dev. SC Grp. LLC*, 517 B.R. at 606 (quoting *Sanford v. Commonwealth of Va.*, 687 F. Supp. 2d 591, 602 (E.D. Va. 2009)).
19 *In re Legacy Dev. SC Grp. LLC*, 517 B.R. at 607-09.
20 *Id.* at 607.
21 *Id.* at 607-08.
22 It is inappropriate for opposing counsel to raise an apparent conflict of interest between his/her adversary's joint clients. *See Derrick v. Nat'l Health Fin. DM, LLC, et al. (In re Derrick)*, No. CV-13-01706-PHX-NVW; Bk. No. 10-BK-36666-SSC, 2014 WL 171845, 6 (D. Ariz. Jan. 15, 2014).
23 *KLG Gates LLP v. Brown*, 506 B.R. 177, 192 (E.D.N.Y. 2014).
24 *Id.* at 192.
25 *Id.*
26 *In re Derrick*, 2014 WL 171845, at *6 (conflict rules are not a tool for strategic elimination of opposing counsel).
27 *In re Madera Roofing Inc.*, No. 13-16954-B-11, 2014 WL 4796758, *5 (Bankr. E.D. Cal. Sept. 25, 2014) (citing *Sec. Bank of Washington v. Steinberg (In re Westwood Shake & Shingle Inc.)*, 971 F.2d 387, 390 (9th Cir. 1992)).
28 *In re Madera Roofing Inc.*, 2014 WL 4796758, at *5.

balance on its books, including through the year-end when law firms traditionally close their books, [counsel] made no effort to disclose its status as a creditor of the Debtor, waive the balance on the account, and address the problem at a time when the court might have been able to enter an order to "equitably" correct the problem.[29]

Likewise, special counsel who was retained in a Ponzi scheme case to seek the avoidance of recipients of the Ponzi scheme transfers was disqualified where counsel continued to represent one of the Ponzi scheme creditors after being retained as counsel for the trustee.[30] An actual conflict of interest existed whereby counsel had taken on a subsequent representation in direct conflict with the theories that counsel advanced for the adverse creditor when it filed a proof of claim for the creditor in the case.[31] Key to the court's decision was that although counsel was employed under § 327(e), counsel failed to comply with his obligations of disclosure under Fed. R. Bankr. P. 2014(a) to avoid actual conflicts of interest.[32]

Disgorgement

Disgorgement of fees is a companion or alternate remedy to disqualification where attorneys fail to properly disclose connections and adverse interests under Fed. R. Bankr. P. 2014(a). Generally, bankruptcy courts have the discretion to reduce fees for an undisclosed conflict.[33] Denial of all fees is permissible, but not required.[34] However, some courts conclude that if a professional was disqualified from employment by virtue of a conflict of interest, or because the professional's employment is otherwise precluded under the provisions of § 327(a), then compensation must be denied and, if already paid, disgorged.[35]

Courts also may apply equitable considerations in determining whether and how much a disqualified attorney must disgorge in previously paid fees.[36] One consideration may be that the attorney provided valuable services in reliance on the court's employment order.[37] "The services performed [must be] outside of any conflict of interest, and the lack of disinterestedness [must] not actually interfere with the professional's representation of the estate."[38]

Avoiding disqualification and/or disgorgement can be accomplished by the responsible disclosure of all connections that might be seen as a conflict or affect "disinterestedness." Counsel should disclose pertinent connections as mandated by Fed. R. Bankr. P. 2014(a) and supplement as required. Mere negligence will not vitiate counsel's duties.[39] abi

29 *Id.* at *7.
30 *Forizs & Dogali PA v. Siegel*, No. 8:12-cv-253-T-23, 2012 WL 4356266, at *1-2 (M.D. Fla. Sept. 24, 2012).
31 The appellate court quoted the bankruptcy judge's explanation: "We're talking about special counsel for the Trustee representing a victim in a Ponzi scheme, being hired by the Trustee to sue other victims of the Ponzi scheme, and then after that retention was approved, filing a claim on behalf of one of the victims with a claim for recovery of amounts that would not be sustainable on a Ponzi scheme theory. It seems like an actual conflict to me." *Forizs & Dogali PA v. Siegel*, 2012 WL 4356266, at *2.
32 *Forizs & Dogali PA v. Siegel*, 2012 WL 4356266, at *3-4.
33 *In re Tribeca Mkt. LLC*, 516 B.R. at 279.
34 *Id.* at 280.
35 *See In re Federated Dep't. Stores Inc.*, 44 F.3d 1310, 1320 (6th Cir. 1995) (section 330(a) clearly requires valid professional appointment under § 327(a) as prerequisite to award of compensation).
36 *Id.* (denying that all fees would be inequitable where advisors rendered valuable services in case).
37 *In re Madera Roofing Inc.*, 2014 WL 4796758, at *9 (citing *First Interstate Bank of Nev. NA v. CIC Inv. Corp. (In re CIC Inv. Corp.)*, 192 B.R. 549, 553-54 (B.A.P. 9th Cir. 1996).
38 *Id.*
39 *In re Madera Roofing Inc.*, 2014 WL 4796758, at *6 (citing *Mehdipour v. Marcus & Millichap (In re Mehdipour)*, 202 B.R. 474, 478 (B.A.P. 9th Cir. 1996)).

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