DISGORGEMENT OF FEES PAID TO A PROFESSIONAL PERSON IN BANKRUPTCY*

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I. INTRODUCTION

Disgorgement. The word itself just sounds bad. Even the spellchecker can't stand it. In very general terms disgorgement implies throwing up, vomiting, or giving up something that one has seized or dishonestly come by.[1] For purposes of this article disgorgement means paying damages for having received compensation in violation of Bankruptcy Code § 327[2] or related rules that govern the hiring and paying of lawyers, accountants and other professional persons in a bankruptcy case. The sin most often occurs in Chapter 11 cases, and therefore I focus on these cases.

The debtor in a Chapter 11 case always needs help, beginning with the need for a lawyer to represent the debtor generally in the bankruptcy case. Lots of other special, expensive help is often needed too. For the most part, however, the money to pay for this help is property of the estate that would otherwise pay creditors or serve other bankruptcy goals that are more important than creating jobs for lawyers and other professionals. In most cases, however, none of the goals of bankruptcy can best be achieved without the debtor in possession getting some professional assistance. To be most effective for the debtor in possession this assistance must come from people who are acting to some higher degree in the interest of the debtor in possession over the interests of themselves or someone else.

Section 327(a)[3] is the principal formula for balancing all these concerns. It empowers the trustee and thereby the debtor in possession to "employ one or more attorneys, accountants, appraisers,

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1. THE NEW LEXICON WEBSTER'S DICTIONARY OF THE ENGLISH LANGUAGE 271 (1989).
2. 11 U.S.C. § 327.
3. 11 U.S.C. § 327(a).

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auctioneers, or other professional persons . . . to represent or assist the trustee in carrying out the trustee's duties under this title."[4] This power, however, is subject to a substantive eligibility requirement and a procedural condition: The debtor in possession can only employ professional persons "that do not hold or represent an interest adverse to the estate, and that are disinterested . . . ." Employing such persons is always conditioned on "the court's approval." Significantly, paying professional persons is also and additionally subject to court approval. Disgorgement results when a professional person is paid even though the person fails the two-pronged eligibility requirement, is paid in violation of the procedure for court approval of employment or payment, or is paid in violation of both the eligibility requirement and proper procedure.

The procedures for employment and payment do not guarantee against hiring and paying a professional person who, it turns out, is ineligible for employment. Looseness in definitions, process, or truthfulness creates holes in the safeguards allowing ineligible persons to slip through. If and when they are finally caught, disgorgement is often based on the double violation that the payment violated the eligibility requirement and also violated procedure because something was done or not done procedurally that masked the person's ineligibility.

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4. 11 U.S.C. § 327(c) and § 1107(a). With the court's approval a creditors' committee may also hire agents to work for the committee, but an attorney or accountant who represents the committee cannot at the same time represent anybody else with an adverse interest in the case. 11 U.S.C. § 1103.

For purposes of § 327(a) a "professional person" is a person whose occupation plays a central role in the administration of the debtor proceeding. U.S. Trustee v. Bloom (*In re* Palm Coast, Mantanza Shores Ltd. Partnership), 101 F.3d 253, 257 (2d Cir. 1996). The real question is the significance of not being a "professional person" within the meaning of § 327. Is a person unemployable if she falls outside this meaning? (Is the trustee or debtor in possession unable to hire a non-professional person to help with the bankruptcy?) Is the non-professional person employable but free of the limitations of § 327 or beyond the protections that a professional person receives?

The answer to these questions may be that any person whose role is essential to bankruptcy is a professional person whose employment is authorized by and subject to § 327. Anybody who plays a lesser role may be employable in the ordinary course (or on another basis) but isn't subject to the eligibility tests of § 327, even though the person may be a professional in ordinary terms. In *In re Yuba Westgold, Inc.*, 157 B.R. 869 (Bankr. N.D Iowa 1993), the court said:

> Not all professionals which might be hired by a debtor-in-possession come within the purview of § 327(a). Professionals that do are those which play an "intimate role in the reorganization of the debtor's estate."

Id. at 872.

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II. THE PROCEDURE FOR EMPLOYMENT AND PAYMENT

Section 327(a) is somewhat misleading on its face. The statute literally provides that the trustee "may employ"[5] certain professional persons. The whole truth is that because court approval is required, the trustee really only nominates persons for employment and the court "approves [or not] candidates so selected."[6] The procedure for approval is designed to expose facts that test the substantive eligibility of the trustee's candidate. The procedure looks for facts showing that the professional person the trustee wants to hire is not disinterested and holds or represents no interest adverse to the estate.

The key procedural rule, Bankruptcy Rule 2014(a),[7] casts a very, very wide net to snare even the smallest signs of ineligibility. Rule 2014 requires the trustee to apply for a court order approving the employment of a professional person and to disclose in the application

> 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.[8]

This 2014 application reports facts that disclose all such "connections."[9] The court then decides as a matter of law if these connections more narrowly amount to ineligibility, either because the connections show that the professional person holds an adverse interest or because they establish that the person is not disinterested.

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5. 11 U.S.C. § 327(a).

6. Harold & Williams Dev. Co. v. U.S. Trustee (*In re* Harold & Williams Dev. Co.), 977 F.2d 906, 909 (4th Cir. 1992).

Work done before court approval is work done for free because the payment of professional fees depends on employment under § 327, which requires court approval except that the order approving employment commonly, retroactively covers work done since filing the application. *Id.*; 11 U.S.C. § 330. A bankruptcy court may grant an afterthought or post facto application for the employment of a professional that covers work done before the application but only if it can be demonstrated that:

1) the employment satisfies the statutory requirements, and
2) the delay in seeking court approval resulted from extraordinary circumstances.

A nunc pro tunc order "should only be entered in the *most* extraordinary circumstances." *In re* Spencer, 48 B.R. 168, 171 (Bankr. E.D.N.C. 1985) (Small, J.) (emphasis added). Tardiness occasioned merely by oversight isn't enough, *In re* Jarvis, 53 F.3d 416, 418 (1st Cir. 1995), even if the court is somehow aware before approval is sought that the services are being provided. *In re* Carolina Sales Corp., 45 B.R. 750 (Bankr. E.D.N.C. 1985) (Small, J.).

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

8. *Id.*

9. *Id.*

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A professional person being approved for employment does not automatically mean that the person will be paid for the work the person performs. A professional person whom the court approves for employment must additionally have her compensation approved by the court.[10] Interim compensation during the bankruptcy is provided for, but it too requires court approval.[11] Here again the process allows for eliminating ethical conflicts. Section 328 plainly permits the court to deny compensation, even though employment has previously been approved, if at any time during employment the

> professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed.[12]

Indeed, the Sixth Circuit interprets this language of § 328 as mandatory rather than discretionary. The bankruptcy court is not free to award compensation despite finding a conflict. Section 328 *requires* denying compensation to a professional person if a conflict is found.[13] Moreover, another court warns that "if a conflict exists, the consequences may be considerably more than a disallowance of the questioned portion of the application."[14] It may require denial of all fees, although

> the bankruptcy judge should not be bound by a completely inflexible rule mandating denial of all fees in all cases. The general rule should be that all fees are denied when a conflict is present, but the court should have the ability to deviate from that rule in those cases where the need for attorney discipline is outweighed by the equities of the case.[15]

The bottom line is that despite the court having approved a professional person's employment and even though this person has worked very hard and very well on the bankruptcy case, the court can entirely or partly refuse to pay the person if: facts have occurred since approval of employment that would now disqualify the person, or disqualifying facts that existed at the time of employment are newly uncovered. Facts of either kind may be disclosed when a trustee, debtor in possession or professional person includes such new facts in a fee application, amends earlier pleadings or

10. 11 U.S.C. § 330.

11. 11 U.S.C. § 331. The procedure for approval of interim compensation is outlined in Bankruptcy Rule 2016(a).

12. 11 U.S.C. § 328(c). A professional person cannot avoid scrutiny by having someone else pay the debtor's lawyer's fees during the bankruptcy. *In re* Rabex Amuru of North Carolina, Inc., 198 B.R. 892 (Bankr. M.D.N.C. 1996) (Stocks, C.J.).

13. Michel v. Federated Dept. Stores, Inc. (*In re* Federated Dept. Stores, Inc.), 44 F.3d 1310, 1319-20 (6th Cir. 1995).

14. *In re* Watson Seafood & Poultry Co., Inc., 40 B.R. 436, 439 (Bankr. E.D.N.C. 1984).

15. *Id.* at 440 (deciding in this case that disallowing all compensation was too harsh).

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otherwise acts honestly to update the record, or because an adverse party somehow uncovers the new facts and reports them to the court when opposing a fee application or otherwise objecting to compensation.

III. THE SETTING FOR DISGORGEMENT

New facts showing ineligibility for employment or compensation can also pop up (or seep out) later—after approval of employment, after approval of compensation, and after the professional person has actually been paid. In this event the remedy is disgorgement. The remedy is usually requested upon motion of an adverse party who discovers that a professional person has been paid despite disqualifying conflicts that were unseen or kept secret from the court.

A good example of the invincibility of disgorgement is the story of *In re Benjamin's-Arnolds, Inc.*[16] On October 30, 1990, the debtor filed Chapter 11 and in due course quickly applied to hire Michael LeBaron as its general bankruptcy counsel along with the Minneapolis law firm of Larkin, Hoffman, Daly and Lindgren ("Larkin"), a very fine firm in which Mr. LeBaron is a respected partner. The application admitted that Larkin was an unsecured, pre-petition creditor but swore that otherwise the firm was disinterested and did not hold or represent any interest adverse to the estate.

On November 20, 1990, the bankruptcy judge, Nancy Dreher, approved hiring Larkin, and the firm served as the debtor's general bankruptcy counsel throughout the case. Interim and final fee applications were made and approved, totaling almost $300,000. Only $103,000 was actually paid. A balance of more than $189,000 remained.

The debtor's plan of reorganization was confirmed in August, 1992. The Chapter 11 case was closed in March, 1993.

In July, 1994, the case was reopened and in October was converted to Chapter 7. Larkin filed claims for fees that were earned but unpaid during the Chapter 11 case and also for post-confirmation services to the debtor.

Somehow the Chapter 7 trustee learned about the possibility of Larkin having several disqualifying connections to the debtor that had existed but had not been disclosed when Larkin was hired in the Chapter 11 case. If these connections really existed, they could or maybe should have been disclosed in the application for employment. These alleged, newly-discovered connections included:

> Larkin had a longstanding attorney-client relationship with virtually all of the debtor's shareholders and their related affiliates;
> one hour prior to the filing of the petition Larkin had assisted in arranging for [Michael] Chamberlain [a shareholder of the debtor],

16. No. 4-90-6127, 1997 WL 86463 (Bankr. D. Minn. Feb. 28, 1997).

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without additional consideration, to take a security interest in the Debtor's assets in the sum of over $840,000;

just prior to the filing of the case Larkin had been paid $17,000 in attorneys fees, that there had been additional payments to Larkin within the preference period, and that some of these fees [only a portion] were for bankruptcy-related work; and

Larkin had continued during the case to represent the principals and related entities, some of whom were creditors of the Debtor.[17]

So, in July, 1996, almost seven years after Larkin had been retained in the Chapter 11 case, the trustee in the Chapter 7 case objected to Larkin's claims for unpaid Chapter 11 fees. The trustee also asked the court to order Larkin to return the fees that were actually paid to the firm almost four years earlier in the Chapter 11 case.

Larkin moved for summary judgment on the remedy of disgorgement. The allegedly disqualifying connections were not tried or proved, and the court did not decide the legal question whether or not such connections would mean that the firm was not disinterested. Larkin conceded that the firm was not for technical, procedural purposes only, arguing essentially that the law does not provide for disgorgement of fees even if the firm was disqualified for employment in the first place. So, in sum, the only issue before the court was the legal issue whether the court had to order disgorgement.

Never prone to mince her words, Judge Dreher flatly, sternly denied Larkin's motion with respect to pre-confirmation fees, opining in unequivocal language that the bankruptcy court was fully empowered to order disgorgement in a proper case.[18]

IV. THE FULL MEANING OF DISGORGEMENT

In this setting, disgorgement is commonly thought of as simply returning fees that were wrongly received. Of course, the money actually paid to the errant lawyer is long gone, having been paid to the lawyer's firm, partners, children, or other creditors. Disgorgement, however, is not an order for return of the money in species. The defense that "the" money is spent will not work. Disgorgement is really an award of damages equaling the amount of fees wrongly received and perhaps more. Interest may be awarded and further damages too.

A good example of additional damages comes from another story, *In re Textiles Industries, Inc.*[19] The debtor's law firm in Chapter 11 bankruptcy was Wyatt, Early, Harris & Wheeler ("WEHW"), another well-respected firm. When hired under § 327 the firm had sworn that it had no connections with the debtor or anybody else

17. *Id.* at *1.
18. *Id.* at *6-*10.
19. No. 95-12517C-11G (Bankr. M.D.N.C. May 28, 1997) (Stocks, J.).

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interested in the case and that the firm represented no adverse interests. The court later found that WEHW had long-standing, extensive connections with the debtor and its shareholders. Also, during the case the firm represented interests adverse to the estate. None of these conflicts was disclosed at the time the court was asked to approve the firm's employment or later when fees were applied for and paid.

Eventually, a Chapter 11 trustee was appointed in the case. This trustee and the unsecured creditors' committee learned of WEHW conflicts in the bankruptcy case. The trustee then asked the bankruptcy court to fire the firm; deny the firm's pending fee applications; order disgorgement of fees the firm had already received; and, additionally, force the firm to reimburse the estate for all fees and costs associated with the firm's violation of § 327, Rule 2014, and related laws. Bankruptcy Judge Williams Stocks sided with the trustee, and with respect to the demand for reimbursement said:

> The failure of WEHW to comply with Bankruptcy Rule 2014 at the time this case was filed and thereafter during the pendency of this case, resulted in many hours of time being spent by the attorney for the Unsecured Creditors' Committee in trying to obtain information about matters which should have been disclosed by WEHW at the very outset of this case. The failure of WEHW to comply with Bankruptcy Rule 2014 also has resulted in the attorney for the Trustee spending numerous hours concluding such investigation, in preparing and briefing the motions which were appropriate once adequate information was obtained and in preparing for and prosecuting the motions. In such a situation, in order to rectify the harm to the estate and in order to make the estate whole, it is appropriate to require such attorneys fees and expenses be reimbursed to the estate by the attorneys whose nondisclosure and conflicts of interest caused the estate to incur the attorney fees and other expenses.[20]

V. THE ARGUMENTS AGAINST DISGORGEMENT AS A REMEDY

There are four principal arguments against a court ordering disgorgement of fees as a remedy for violation of § 327 and related laws and rules. Some of the arguments are general and fundamental and oppose disgorgement in all or many cases. Other arguments are narrow and fact specific and depend on special circumstances in the particular case. None of the four arguments works, except (very rarely) the argument of equity.

A. LACK OF AUTHORITY

The broadest argument is that the bankruptcy court lacks authority to order disgorgement because the law does not provide for the

20. *Id.*, slip op. at 61-62.

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remedy. The Larkin firm made this argument in *Benjamin's-Arnolds* and so did the Wyatt firm in *Textiles Industries*. It is equivalent to telling the judge, "Even if I didn't fully disclose and took money I shouldn't have been paid for work I wasn't eligible to do, you lack the power to order me to give it back. So there."

The argument predictably fails even though the Code and the Rules say nothing about disgorgement as a remedy for violating § 327 or related laws. Section 329 explicitly empowers a court to order the return of excessive fees,[21] and § 549 provides for avoiding post-petition transfers of estate property that are not authorized by statute or the court.[22] These provisions do not apply when fees are paid in violation of § 327, however, because the court approved the fees and the problem is not that the fees are excessive.

The inapplicability of §§ 329 and 549, both of which explicitly provide for disgorgement, might seem to argue implicitly, even powerfully, that the court lacks authority to order disgorgement for violating § 327 and kin which are silent on disgorgement. Especially strong is the inference that comes from comparing §§ 328 and 329. They are literally side by side in place and principle. Section 328(c) enforces § 327 by denying compensation to a professional person who fails the § 327 requirements for employment in the case.[23] Section 329 effectively requires reasonable fees, allows the court to deny payment of fees that would violate this requirement, and goes further by allowing the court to order the return of excessive fees actually paid in violation of the requirement.[24] Because § 329 is so close and expressly authorizes disgorgement, the contrasting silence of §§ 327 and 328 about disgorgement is stereophonically loud.

Paradoxically, Judge Dreher believes that § 328(c) is the root of the court's power to order disgorgement for violating the eligibility requirements of § 327. She wrote in *Benjamin's-Arnolds*:

> [I]t is clear that § 328(c) does not expressly authorize the court to order the disgorgement of fees received by a conflicted attorney. It is equally clear, however, that the provisions of § 328(c) are meant to empower the court to prevent an attorney who fails the standards of § 327 from receiving compensation from the estate. Therefore, this Court concludes that the power to order conflicted professionals to disgorge wrongfully received compensation is necessary to effectuate the statutory objective of § 328(c).[25]

Judge Dreher does not say that § 328 itself authorizes disgorgement. Rather, she expertly restates § 328 as a broad enforcement principle

21. 11 U.S.C. § 329(b).
22. 11 U.S.C. § 549(a).
23. 11 U.S.C. § 328(c).
24. 11 U.S.C. § 329(b).
25. *In re* Benjamin's-Arnolds, Inc., No. 4-90-6127, 1997 WL 86463, *10 (Bankr. D. Minn. Feb. 28, 1997).

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behind § 327 and then uses § 105[26] as the technical source of authority for the particular remedy of disgorgement. Section 105 is the blank check of judicial power, authorizing bankruptcy courts to do anything "necessary or appropriate to carry out the provisions"[27] of the Bankruptcy Code. What § 328 provides in principle, says Judge Dreher, can and must be fully "carried out" on the basis of § 105 by ordering disgorgement of fees "where the receipt of such fees was in violation of § 328(c) and where the court's order allowing the fees was made in the absence of full disclosure."[28]

Section 105 is the common, favorite authority for disgorgement, but is not the only authority. Courts commonly stand on additional, alternative grounds when they order disgorgement. Some alternatives are even more general than § 105 and others are much more specific.

The widest authority for disgorgement is a court's inherent power to do stuff, especially including regulating the practice of lawyers before the court. The narrowest authorities are various procedural rules that deal with practice.

Uncommon, but solid, authority may also be the age-old law of restitution[29] which pervades the federal and local law and procedure that bankruptcy courts receive and apply.

Nothing, however, is really any clearer, better authority for disgorgement than § 105 if the "provisions" of §§ 327 and 328 include something beyond the literal language that requires disgorgement "to carry [it] out." Given this reading of §§ 327 and 328, no further authority is needed beyond § 105. It is sufficient.

B. FINALITY OR OTHER PRECLUSION

Sometimes lawyers argue that courts are estopped or otherwise precluded from ordering disgorgement because of notions of finality or the like that, the lawyers say, effectively seals a court's order approving compensation. This argument very quickly fails. An interim award of fees is, by name and nature, not final. Even a final award can be undone that is based on mistake or fraud, or if other good reason exists. Typically, the violation of § 327 involves incomplete disclosure that is fully sufficient reason to deny the protection of finality or other preclusion.

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26. 11 U.S.C. § 105(a).

27. *Id.*

28. *In re* Benjamin's-Arnolds, Inc., No. 4-90-6127, 1997 WL 86463, *10 (Bankr. D. Minn. Feb 28, 1997).

29. Restitution is the principle and remedy, in various forms, when a person has been unjustly enriched at the expense of another person. RESTATEMENT OF RESTITUTION § 1 (1937). Restitution traditionally, broadly provides for recovering money paid upon mistake of law or fact. *Id.* §§ 15-28, 44-45.

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C. MISTAKE OR NEGLECT IN FAILING TO DISCLOSE

"I didn't mean to" or "I didn't know" is not, in itself, a good defense. The purposes behind § 327 are so important that conscious culpability is not required for disgorgement, and the professional person fully bears the burden of finding and disclosing connections and conflicts. This person—not the bankruptcy estate—takes the risk of full information, and she has strict responsibility of full disclosure, without regard to the size and range of her professional practice or the secrecy of relationships between her other clients and the debtor.

D. EQUITY

Innocent culpability may not itself defend against disgorgement but is an essential ingredient of a wider, squishy defense based on "equity" or other judicial discretion in ordering the remedy. The courts will recognize in theory an equitable or discretionary exception to disgorgement; but the exception is very tiny and in practice rarely fits any case and never predictably.

An example of such a rare fit is *In re Federated Department Stores, Inc.*[30] In this very big, very complicated case the debtor nominated Lehman Brothers to serve as financial advisor. Lehman fully disclosed all connections as the code requires. The trustee objected on various grounds, including Lehman's recent past service as the debtor's investment banker. On this ground alone Lehman was technically disqualified for employment because the Code defines disinterested in part to require that the person "is not and was not, within two years before the date of the filing of the petition, an investment banker for a security of the debtor . . . ."[31] Lehman thus was not disinterested, as § 327 requires.

The bankruptcy court overlooked this "technicality" when approving the Lehman's employment and repeatedly again when approving interim awards of compensation. Bankruptcy Judge Aug plausibly reasoned that in the absence of any actual conflict, the cost of only technically violating § 327 should be weighed against the value of Lehman's expertise, including expertise with the debtor based on past dealings between them. After all, § 328(c) plainly says that the judge "may" deny compensation to a professional person employed under § 327 if the person at any time during the employment is not disinterested.[32]

Five years passed from the time Judge Aug approved Lehman's employment to the time the Sixth Circuit decided whether Judge Aug's balancing approach was right. In the interim, the Sixth Circuit decided *Childress v. Middleton Arms, L.P. (In re Middleton*

30. 44 F.3d 1310 (6th Cir. 1995).
31. 11 U.S.C. § 101(14)(C).
32. 11 U.S.C. § 328(c).

Arms Ltd. Partnership).[33] This case held that a bankruptcy court lacked equitable power and other discretion to ignore the literal language of the Code prohibiting the employment of an interested person. In *Middleton Arms* the court discounted the word "may" in § 328(c) and read the provision to require denying compensation to a person who was or has become disqualified—even if the conflict is technical only and not a real conflict.

In light of *Middleton Arms*, the Sixth Circuit decided in *Federated Department Stores* that Judge Aug was wrong to approve employing Lehman and was repeatedly wrong to approve payments of compensation to Lehman. Disgorgement of all fees paid to Lehman was appropriate, but the Sixth Circuit was lenient and ordered only partial disgorgement because:

> denying all compensation to Lehman Brothers would not be equitable. . . . It is conceded that Lehman Brothers rendered valuable services to Federated during the reorganization. Until *Middleton Arms* was decided, there was no definitive appellate court decision which has come to our attention that determined the question of Lehman Brothers' qualifications to served as Federated's financial advisor despite its interested status.
>
> Under these peculiar and unique circumstances, which are not likely to be repeated again in light of the now settled law in this circuit, we are of the view that fairness and equity dictate allowing Lehman Brothers to be compensated at its agreed rate up to June 6, 1991 [when *Middleton Arms* was decided], but not beyond. Any fees and costs allowed and paid to lehman Brothers in this case after June 6, 1991, will be promptly refunded to the bankrupt debtor. After that date on which *Middleton Arms* was decided, Lehman Brothers is charged with the knowledge that it was proceeding at risk and beyond the equitable authority of the bankruptcy court to effect further compensation.[34]

VI. THE ONLY REAL DEFENSE TO DISGORGEMENT—THE MERITS OF THE CLAIM AND THE MEANING OF CONFLICT

The only indisputable, predictable defense to disgorgement for violation of § 327—really the *only* defense—is that § 327 was not violated: the professional person was qualified or not ineligible under § 327 because the person was disinterested throughout employment in the case and during such time held or represented no adverse interest.[35] This defense goes to the merits of the claim for disgorgement and is undoubtedly a good defense in every case in which eligibility can be established. The big problem is establishing

33. 934 F.2d 723 (6th Cir. 1991).

34. *Id.* at 1319-20.

35. Even this defense may face if despite this cleanliness, the professional person fail to disclose all connections under Rule 2014 or benignly violates other procedural requirements for approval of employment or compensation.

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eligibility because the dual requirements are so large, in some respects rigidly defined, and yet not fully defined so that the requirements are open ended.

Especially troublesome is the requirement that the professional person is "disinterested."[36] The definition is long and detailed:

> [D]isinterested person means person that—
>
> (A) is not a creditor, an equity security holder, or an insider;
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> (B) is not and was not an investment banker for any outstanding security of the debtor;
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> (C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor;
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> (D) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor or of an investment banker specified in subparagraph (B) or (C) of this paragraph; and
>
> (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 or an investment banker specified in subparagraph (B) or (C) of this paragraph, or for any other reason . . .[37]

Therefore, if the statute is read and applied literally, a lawyer is not disinterested to whom the debtor owes a pre-petition debt, whether or not the debt relates to the bankruptcy case, because the lawyer is a "creditor." Or, as *Federated Department Stores* teaches, a financial services firm is not disinterested solely for the reason that the firm was the debtor's "investment banker" prior to the bankruptcy case.[38] The banker's "attorney" is derivatively, equally disqualified.[39] Technically, the existence of an actual conflict as a result of any of these connections is not required, and the lack of an adverse interest is not an additional requirement. Failing the disinterested test and having or representing an adverse interest are alternative reasons for ineligibility. Each reason alone is sufficient to disqualify a professional person under § 327.

The definition of disinterested is chocked full of job categories that are specific but very wide in meaning. These categories are also very wide in the sense of covering many particular persons whom the debtor would likely want to hire in a bankruptcy case, such as the lawyers and financial advisors who have customarily served the debtor and know well the debtor's business and its people.

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36. 11 U.S.C. § 327(a).

37. 11 U.S.C. § 101(14).

38. 11 U.S.C. § 101(14)(C); *In re* Federated Department Stores, 44 F.2d 1310, 1318-19 (6th Cir. 1985).

39. 11 U.S.C. § 101(14)(C).

The range of people who are disqualified under § 327 is also large because some terms are very unspecific. The statute does not even attempt to define the alternative disqualification "adverse interest;"[40] and even though "disinterested" begins and goes on and on with such specificity, the definition ends with "for any other reason."[41] Additionally, the courts say that professional persons may be disqualified for reasons outside the requirements and definitions of § 327.

In sum, the risk of ineligibility is high, especially for lawyers who regularly work in bankruptcy and related fields. The gamble is compounded by the uncertainty that results because courts differ and shift on how they read the law and because even the clearest opinions are very fact specific and offer very little precedent protection in other cases.

The law gives very little, barely reliable advice even for the most common and important situations.

A. DEBTOR OWES PRE-PETITION FEES TO LAWYER WHO IS (OR WANTS TO BE) GENERAL BANKRUPTCY COUNSEL (OR THE LAWYER FOR OTHER REASON IS TECHNICALLY NOT DISINTERESTED)

A lawyer who is owed a pre-petition debt is a creditor and for this reason alone is not disinterested. Therefore, this lawyer is ineligible for employment in the bankruptcy case if § 327 is literally applied. Some "authorities" do not apply the language completely literally. Rather, they apply the law with varying degrees of looseness that consider purposes and practicalities. For example, a few courts consider relevant whether the fees arise from the bankruptcy proceedings or unrelated matters. The lawyer's status as creditor might not disqualify her if the debt is for the lawyer's services in contemplation of the bankruptcy case.[42]

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40. 11 U.S.C. § 327(c).

41. 11 U.S.C. § 101(14)(E). For this purpose a general definition of "disinterested" is necessary, and in implying or inferring such a core meaning the courts should observe that in modern usage "disinterested" and "uninterested" are not synonymous. WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 363-64 (1988). "Disinterested" allows interest that is impartial.

42. *In re* Textile Industries, Inc., 198 B.R. 902 (Bankr. M.D.N.C. 1996) (accounting firm disqualified "by virtue of its status as a creditor of the debtor both at the time of the filing of the debtor's peition and at the time of the application for appointment as accountants for the debtor."); *see In re* Seminole Oil & Gas Corp., 963 F.2d 368, n.5 (4th Cir. 1992); *see also In re* Roberts, 46 B.R. 815 (Bankr. D. Utah 1985) ("[A] law firm serving as general counsel for a debtor in possession, which is owed on the date of filing a pre-petition debt for legal fees or costs incurred solely for services rendered in contemplation of an in connection with the bankruptcy case, does not because of this debt hold as interest adverse to the estate nor does it lack disinterestedness . . . . In this situation, these pre-petition fees and costs are recoverable as part of the fees allowed . . . .")

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A few courts and more law professors would wholesale add another condition to the whole meaning of disinterested. They would ignore a technical lack of disinterestedness on any basis and look instead for materially adverse interest. Absent an actual conflict, a professional person is not disqualified solely because she is not disinterested within the statutory definition.

Most lawyers attempt to avoid the conflict by making sure that all fees have been paid at the time of bankruptcy or by waiving prepetition fees. This tactic and any other arguments against ineligibility are certainly less reliable if somebody can argue that any prepetition payments to the lawyer are viable preferences.

Off the record, debtors' bankruptcy lawyers sometimes dream about altogether avoiding the disinterestedness and other requirements of § 327(a) by coming into the case as in-house counsel through § 327(b), which provides:

> If the trustee is authorized to operate the business of the debtor under section 721, 1202, or 1108 of this title, and if the debtor has regularly employed attorneys, accountants, or other professional persons on salary, the trustee may retain or replace such professional persons if necessary in the operation of such business.[43]

Section 327(b) is a complete exception to § 327(a) and other rules on the employment of professionals. Nothing in subsection (a) applies to (b): no court approval, no disinterested requirement, no fee application, no thing. The subsection (b) exception is intended for genuine "in house" attorneys, accountants, and the like. This exception is certainly subject to manipulation and abuse by debtors, but the courts police its use fairly closely.

In the case *In re Bartley Lindsay Co.*,[44] the debtor hired a workout specialist as president. The arrangement was a new twist on the old employee versus independent-contractor maneuver. Judge Bob Kressel decided that the § 327(b) exception did not apply. Being an officer does not in itself immunize a professional person from § 327(a). Substance controls so that in this case the workout specialist's employment was controlled by § 327(a).[45]

Judge Small much earlier reached the same result in *In re Carolina Sales Corp.*[46] The court held that a management consultant was a professional person who could not escape § 327(a) as an "in-house" professional under § 327(b).

43. 11 U.S.C. § 327(b).

44. 120 B.R. 507 (Bankr. D. Minn. 1990).

45. *See also In re* Yuba Westgold, Inc., 157 B.R. 869 (Bankr. N.D. Iowa 1993) (§ 327(b) does not apply when replacing in-house professionals with independent contractors, such as an affiliate and creditor that the debtor wanted to hire for management services).

46. *In re* Carolina Sales Corp., 45 B.R. 750 (Bankr. E.D.N.C. 1985).

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> By referring to a regularly employed professional person on salary, the Bankruptcy Code envisions an existing department within a company or in-house counsel, who will be helpful to the trustee in handling routine matters incident to normal business activity. At all times, Strategic Options [the professional person in this case] operated as an independent contractor in its relationship with the debtor, not as a salaried employee.[47]

In light of these cases a debtor probably could not replace usual in-house counsel with a lawyer who is a bankruptcy specialist. Even if this arrangement survived the *Bartley Lindsay* analysis, it is unlikely that either a creditors' committee or a court would accept that such a person is "necessary in the operation of the business,"[48] as § 327(b) requires. Indeed, management would typically be the first to argue that bankruptcy lawyers are anything but "necessary in the operation of the business."

A limited end run around the disinterested requirement of § 327(a) is subsection 327(e).[49] This provision permits hiring an attorney and requires only that the attorney does not hold or represent an adverse interest. On the other hand, this exception is limited to hiring the person only for a "specified special purpose"[50] and cannot be used as a basis for employing general bankruptcy counsel.

B. DEBTOR'S LAWYER REPRESENTS A CREDITOR

Section 327(c) overrides § 327(a) and plainly provides that the debtor's lawyer can also represent a creditor so long as no one objects, and any objection is overruled if the court finds no actual conflict of interest.[51] Lawyers are doubtful how far this language protects them.

At a minimum subsection (c) means that a lawyer is not disqualified from serving as the debtor's general counsel solely because the lawyer has represented a creditor in the proximately remote past.[52] Also, representing the creditor and the debtor during the bankruptcy is okay if the lawyer is hired for a special purpose and the

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47. *Id.* at 753.

48. 11 U.S.C. § 372(b).

49. 11 U.S.C. § 327(e), which provides: "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."

50. 11 U.S.C. § 327(e).

51. "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." 11 U.S.C. § 327(c).

52. *In re* Seminole Oil & Gas Corp., 963 F.2d 368 (4th Cir. 1992).

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creditor whom the lawyer represents has no adverse interest.[53] In theory no per se rule prevents the debtor's general bankruptcy counsel from also representing an exiting creditor during the bankruptcy so long as no actual conflict exists. Indeed, if the creditor is unsecured, the statutory principle of equal treatment is some insurance against the creditor whom the debtor's lawyer represents getting better treatment than other creditors.[54] Probably, however, the threshold for finding a disqualifying actual conflict is lower when the lawyer is general counsel rather than counsel for a limited purpose and is probably even lower if the creditor the lawyer represents is a secured creditor.

C. SOMEBODY IN THE DEBTOR'S LAWYER'S FIRM IS DISQUALIFIED

Whether a lawyer who herself is qualified is barred from employment because someone in her firm is disqualified depends on whether local ethical rules apply that impute universal disqualification to all members of the lawyer's firm. In the case *In re Leisure Dynamics, Inc.*,[55] Judge Bob Kressel decided that the disqualification of any partner in a firm is automatically imputed to every partner in the firm. In contrast, Judge Arthur B. Federman said in *In re Creative Restaurant Management, Inc.*,[56] that disqualification of the entire firm is not automatic and actual conflict must be proved.

Disqualification may be contained and not spread throughout the firm by creating a "Chinese wall"[57] around the infected lawyers.[58] Some conflicts, however, may be too large to wall off. In *In re Trust*

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53. National Westminster Bank U.S.A. v. Yaeger (*In re* RPC Corp.), 114 B.R. 116 (Bankr. M.D.N.C. 1990).

54. *Id.* at 120.

55. 32 B.R. 751, supp. op., 32 B.R. 753 (Bankr.), *aff'd*, 33 B.R. 121 (D. Minn. 1983) (Code of Professional Responsibility).

56. 139 B.R. 902 (Bankr. W.D. Mo. 1992) (Model Rules).

57. "The term 'Chinese wall' refers to any set of physical and procedural barriers intended to prevent one member of organization, such as law firm, from being exposed to information relating to matter currently or formerly handled by one of his colleagues." Roberts v. Hutchins, 572 So. 2d 1231, 1234 n.3 (Ala. 1990). "The term, 'Chinese wall' is a fictional device used as a screening procedure which permits an attorney involved in an earlier adverse role to be 'screened' from other attorneys in the firm. Typically, these procedures include prohibiting the attorney in question from any contact with the case. This may be done by restricting access to files, informing the attorneys working on the case of the barrier and assuring that it is maintained, and sometimes actually separating the attorney in question from those attorneys who are handling the case. The attorney in question does not receive a share of the fees from the litigation. Employment of this device prevents disqualification of the entire law firm simply because one member of the firm previously represented a client who is now an adversary of a client currently represented by the firm." Weglarz v. Bruck, 470 N.E.2d 21, 24 (Ill. App. Ct. 1984).

58. Vergos v. Timber Creek, Inc., 200 B.R. 624 (W.D. Tenn. 1996) (law firm not disqualified because partner was also a director and owner of debtor where firm erected appropriate chinese wall or screening devices to insulate law firm from disqualified partner); *In re* Chicago South Shore and South Bend Railroad, 101 B.R. 10 (Bankr. N.D.

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America Service Corp.,[59] the issue was whether an accounting firm could work for the debtor that last worked for a creditor. The court said, "allowing dual representation by professionals, where the representation is unrelated or so de minimis, or a procedure which is a 'Chinese wall' would be a protective measure, is a possibility."[60]

The court also said that such a wall "is generally not an acceptable means of conflict avoidance where the same professional organization actively represents two adverse interests."[61] In this case the conflict was too great because the creditor the accounting firm represented was the debtor's largest creditor and the firm was doing work for the creditor that was against the debtor's interest. Plus, the evidence suggested that the wall the firm erected had been breached.

VII. THE LEGISLATIVE NARROWING OF THE CLAIM OF INELIGIBILITY AND THEREBY THE REMEDY OF DISGORGEMENT—TWO VIEWS

Congress and the courts have progressively softened § 327. The eligibility requirements for employment of professional persons have loosened and become more lenient. As a result, the claim of ineligibility has become harder to establish. The remedy of disgorgement for violating § 327 has concomitantly narrowed.

Several times Congress has weakened § 327. For example, in the beginning a debtor's lawyer was flatly prohibited from simultaneously representing a creditor. Now the statute expressly approves such dual representation absent objection or actual conflict.[62] Similarly, a lawyer for the creditors' committee was flatly barred from also representing individual creditors or any other interested entity. Now the statute approves in the absence of adverse interest.[63]

Some courts, acting legislatively, have also softened § 327. The best example is the judicial approach that refuses to apply literally the definition of disinterested, adding gloss that disqualifies a person who is not disinterested only if an actual conflict exists. Even courts that may honor the letter of the definition will not stretch its strictness, saying that courts should not develop per se rules beyond those in the statute itself.[64]

Ill. 1989) (law firm could be hired only if firm erected Chinese wall to segregate attorneys who had formerly represented debtor's sister corporation).

59. 175 B.R. 413 (Bankr. M.D. Fla. 1994).

60. *Id.* at 421.

61. *Id.*

62. 11 U.S.C. § 327(c).

63. 11 U.S.C. § 1103(b).

64. Harold & Williams Dev. Co. v. U.S. Trustee (*In re* Harold & Williams Dev. Co.), 977 F.2d 906 (4th Cir. 1992) (no per se prohibition of lawyer acting also as accountant for debtor); *see also In re* Rabex Amuru of North Carolina, Inc., 198 B.R. 892 (Bankr. M.D.N.C. 1996) (rejects per se rule against debtor's lawyer being paid by person or entity other than the debtor).

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Lawyers, too, have weakened § 327 by contriving technical fixes and workarounds that, in form, avoid conflicts. Waivers and Chinese walls are good examples. Courts frequently play along with this charade.

So, all the principal players—Congress, the courts, and bankruptcy lawyers themselves—have worked separately and together to narrow the disqualifications (and thus widen the eligibility) for working as a professional person in bankruptcy cases. Not surprisingly, therefore, the Bankruptcy Review Commission has unanimously voted to codify these efforts, agreeing with Professor King's recommendation that

> Professionals retained by a debtor in possession in a Chapter 11 case should not have to meet the disinterestedness requirement of 11 U.S.C. § 327(a). The deletion does not change the requirement that such professionals (i) not have any interest materially adverse to the estate or (ii) disclose all potential conflicts to the court.[65]

A cyclical view is that lawyers are simply changing the rules to accommodate bad habits and sad ethics. Another view is that this change aligns bankruptcy ethics with usual, long-standing ethical standards. These familiar standards are understood and are more predictable and reliable. They avoid true conflict without artificially shrinking the pool and raising the costs of good lawyers and other professionals who are essential to bankruptcy policy and practice.

65. Memorandum from Professor Lawrence P. King and Elizabeth I. Holland to National Bankruptcy Review Commission and Professor Elizabeth Warren (August 22, 1996).

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