Fiduciary Duties and Conflict of Interest Issues in Representing Small Business Owners

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I. Fiduciary Duties

a. What is a Fiduciary Duty?

i. A fiduciary duty is the highest standard of care in equity or law. A fiduciary is expected to be extremely loyal to the person to whom he owes the duty such that there must be no conflict of duty.

b. Who has a Fiduciary Duty?

i. Officers & Directors
   1. Every director owes fiduciary duties to the corporation and its shareholders.
   2. Since directors can be subject to personal liability for breaches of these duties, it is important that they understand their obligations under law.
   3. Ultimate responsibility for the business and affairs of the corporation belongs to the board of directors.
   4. Shareholders have two fundamental rights:
      a. To elect directors to the board.
      b. To exit the corporation by selling their shares.
   5. The shareholders do not manage the corporation.
   6. No less true when there is a majority shareholder.
   7. The board makes decisions on behalf of the corporation by:
      a. Appointing officers who run the day-to-day operations of the corporation, propose strategies and objectives, and implement corporate plans.
      b. Supervising those officers.
      c. Making major decisions for the corporation (for example, selling the company or entering into a significant joint venture).

ii. The Fiduciary Duties of the Board of Directors
   1. The core fiduciary duties of the board of directors are:
      a. The ***duty of care***.
         i. The duty of care requires that directors be informed of all material information reasonably available to them when making decisions for the corporation.
         ii. A director must act with the care that a person in a like position would reasonably believe appropriate under similar circumstances.
         iii. Directors have no *per se* duty to maximize the profits of the corporation.
         iv. Directors can take actions (for example, charitable donations) that do not directly increase profits, as long as there is a connection to a rational business purpose.
      b. The ***duty of loyalty***.
         i. The duty of loyalty requires directors to act in good faith for the benefit of the corporation and its shareholders, not for their own personal interest.

ii. Corporate opportunity doctrine: an officer or director may not divert to himself or his affiliates any business opportunity presented to, or otherwise rightfully belonging to, the corporation.
iii. The corporation can renounce its interest in specified business opportunities in its certificate of incorporation or by board action.
iv. Conflict transactions:
1. If half or more of the directors hold a personal interest in a transaction, or if half or more of the directors are not independent, they lose the presumption that they acted in the best interest of the corporation.
2. Directors are not deemed to have breached their fiduciary duties just because they were not disinterested and independent.
3. However:
a. Their decisions will be judged for their fairness.
b. If found liable, their liability cannot be exculpated away.

2. Other duties like the duty of good faith and duty of oversight stem from the core fiduciary duties.
i. Good Faith / Bad Faith
1. There is no single definition of good faith or bad faith.
2. To act in good faith, a director must act with honesty of purpose and in the best interest of the corporation.
3. Situations that usually involve bad faith:
a. An **intentional failure to act** in the face of a known duty to act, demonstrating a **conscious disregard** for one's duties.
b. A **knowing violation** of the law.
c. Acting **for any purpose other than advancing the best interests of the corporation** or its shareholders.
4. Beyond gross negligence. Actual or constructive knowledge required.
3. Business Judgment Rule
a. In making business decisions, directors are generally protected by the business judgment rule.
b. The rule presumes that disinterested and independent directors acted:
i. On an informed basis.
ii. In good faith.
iii. In the honest belief that the action was taken in the best interest of the corporation.
c. **Informed.** Directors must inform themselves of all material information reasonably available to them.
i. Directors can rely on information and opinions from consultants and management, if those persons can competently produce those reports.
d. **Good faith.** The decision-making process must be substantive and cannot just rubber stamp management's actions.
e. **Best interest of the corporation.** The directors must reasonably believe the action was taken in the best interests of the corporation.
4. The standard for a finding of breach is gross negligence.

5. Corporate Waste
    a. If the plaintiff fails to rebut the presumption of the business judgment rule (no conflict of interest, no bad faith, no gross negligence) = no remedy unless the challenged transaction constitutes waste.
    b. Stringent standard that is only met in the "rare, unconscionable case where directors irrationally squander or give away corporate assets."
    c. Spending on items such as employee vehicles, outings, social club dues and holiday gifts has been found to not constitute waste.

c. Fiduciary Duties owed by Attorney

i. Duty owed to Client
    1. Loyalty
    2. Care
    3. Confidentiality
    4. Avoid conflict of interest

ii. Duty of Candor to Court
    1. Disclosure
    2. Certain conflicts cannot be waived

iii. Who is the client?
    1. Counsel for a Chapter 11 debtor owes a fiduciary duty of loyalty and care to its client, which is the debtor-in-possession, not the debtor's principals. *In re Angelika Films* 57th, Inc., 227 B.R. 29, 39 (Bankr. S.D.N.Y. 1998), aff'd, 246 B.R. 176 (S.D.N.Y. 2000).

II. Potential Conflicts of Interest

a. Interest of Individual vs. Interest of Company

i. Ownership of Company
    1. Is the company solely owned by individual?
    2. Rights of other owners
ii. The interest of an equity holder is likely extinguished in a bankruptcy proceeding
iii. Type of business
    1. Personal services vs. manufacturer with tangible assets
        a. Disposition of company assets
        b. Continuity of the business operations
    2. Potential for successor liability

b. Tax Debts

i. Are the tax debts the type that would create fiduciary obligations ("trust fund taxes")?
    1. Unpaid sales tax
    2. Unpaid payroll withholding
ii. These debts can likely create personal liability to owners, officers, and potential responsible parties.

c. Personal Guarantees

i. SBA Loans typically require the personal guarantee of the owner/principal.
ii. The principal's interest in allocating resources toward debts for which he/she is personally liable may create conflict of interest (possibly not if secured debts already have priority).

d. Insider Interests

i. Property leased by company, owned by individual
   1. Interest of landlord vs. interest of tenant
   2. Possible claim that "excessive rent" could be construed as a fraudulent transfer to an insider

ii. Company equipment owned company or owned by individual?
   1. Check purchase records

iii. Compensation to insiders

e. Guaranty of legal fee by Insider

i. May create conflict of interest for attorney

ii. Must disclose

f. Prior representation of creditor

i. Must be disinterested and not adverse

ii. Generally, a past representation of a creditor is not grounds for disqualification but should be disclosed and evaluated to determine if attorney remains disinterested.

g. Obligation to prosecute a claim against a principal

i. Preference claims

ii. Fraudulent Transfer claims

h. Best Interest of the Estate vs. Best Interest of the Individual

III. Employment as a Professional in a Bankruptcy Case

a. Professionals may be retained with Bankruptcy Court approval based on a showing of the professional's ***disinterestedness*** and lack of interests adverse to the estate. Court approval of the retention of professionals is subject to significant disclosure obligations and conflict of interest rules.

b. To ensure the ***disinterestedness*** of the professionals, conflicts of interest are more strictly interpreted in bankruptcy than in other areas of the law. Certain conflicts that a client can waive after full disclosure outside of bankruptcy (such as simultaneous representation of a client and a client's creditor) cannot be waived in bankruptcy. Even potential conflicts must be avoided. The Bankruptcy Code's strict conflict of interest requirements help ensure undivided loyalty and promote public confidence in the bankruptcy process.

c. An attorney who, at any time, fails to meet the Bankruptcy Code's requirements for employment by a debtor is subject to having both compensation for services and reimbursement of expenses denied. Bankr.Code, 11 U.S.C.A. §§ 327(a), 328(c).

i. **11 U.S.C § 327**

(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.

(b) 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.

(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.
(d) The court may authorize the trustee to act as attorney or accountant for the estate if such authorization is in the best interest of the estate.
(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.
(f) The trustee may not employ a person that has served as an examiner in the case.

d. Adverse Interest to the Estate

i. For purposes of determining an attorney's qualification to be employed by the estate, an "adverse interest" may be defined as:
   1. to possess or assert any 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. Bankr.Code, 11 U.S.C.A. §§ 327, 330.

e. Purpose of Restrictions

i. Purpose of Bankruptcy Code provisions precluding debtor from employing "professional person" who is not "disinterested" is to prohibit anyone to act in role of professional where interest of professional is patently and obviously adverse to interest of bankruptcy estate, and also to interest of debtor, and interest of professional who holds prepetition claim is most likely not in line with interest of general estate. *In re River Ranch, Inc.*, Bkrtcy.M.D.Fla.1994, 176 B.R. 603.

ii. Bankruptcy Code provision on employment of professional persons is prophylactic provision designed to insure that undivided loyalty and exclusive allegiance required of fiduciary to estate is not compromised or eroded. *In re Prudent Holding Corp.*, Bkrtcy.E.D.N.Y.1993, 153 B.R. 629.

IV. What it Means to Be Disinterested and Without Adverse Interests

a. Definition of Disinterested

i. To represent a Debtor (Debtor in Possession), an attorney or other professional must be disinterested (§ 327(a), Bankruptcy Code).

ii. The Bankruptcy Code defines a disinterested person as one that:
   1. Is not a creditor, an equity security holder or an insider.
   2. Is not and was not, within two years before the petition date, a director, officer or employee of the debtor.
   3. 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. (§ 101(14), Bankruptcy Code.)

b. The disinterested and no adverse interest requirements of section 327(a) of the Bankruptcy Code take into account a law firm's duty of loyalty to its clients as well as the duty to avoid the appearance of impropriety. On these bases, courts have held that professionals are precluded from representing significant creditors or other parties in interest ***even if:***

i. The creditor representation is unrelated to the debtor's Chapter 11 case.
ii. The creditor represents a small percentage of the firm's revenues.
iii. The creditor and the debtor consent to the dual representation.
iv. Counsel fully discloses the representation in compliance with Federal Rule of Bankruptcy Procedure 2014.

c. For example, see *In re Project Orange Assocs., LLC*, No. 10-12307, 2010 WL 6982728 (Bankr. S.D.N.Y. Apr. 29, 2010); *In re Premier Farms L.C.*, 305 B.R. 717 (Bankr. N.D. Iowa 2003); *In re Granite Partners, L.P.*, 219 B.R. at 33).

d. The tests for disinterestedness and lack of adversity invoke the same consideration of whether the professional holds or represents an adverse interest to the interests of the debtor and its estate (see *In re Martin*, 817 F.2d 175, 180 (1st Cir. 1987); *In re Project Orange Assocs., L.L.C.*, 431 B.R. 363, 370 (Bankr. S.D.N.Y. 2010); *In re Granite Partners, L.P.*, 219 B.R. at 33).

e. "Interest"

i. Several courts define the phrase, an interest adverse to the estate, as:

1. To possess or assert any economic interest that tends to lessen the value of the bankruptcy estate or that creates either an actual or potential dispute in which the estate is a rival claimant.
2. A predisposition under circumstances that renders a bias against the estate.

ii. See *In re Arochem Corp.*, 176 F.3d 610, 623 (2d Cir. 1999); *In re Crivello*, 134 F.3d at 835; *In re WorldCom, Inc.*, 311 B.R. 151, 163 (Bankr. S.D.N.Y. 2004); *In re Premier Farms L.C.*, 305 B.R. at 720; *In re Granite Partners, L.P.*, 219 B.R. at 33; *In re Caldor, Inc.-NY*, 193 B.R. 165, 171 (Bankr. S.D.N.Y. 1996); *In re Roberts*, 46 B.R. 815, 827 (Bankr. Utah 1985)).

V. Attorney Conflicts of Interest

a. Actual versus Potential Conflict of Interest

i. Courts are divided on the proper application of conflict of interest standards for retention of the DIP's professionals. An actual conflict of interest will result in disqualification. Even where there is no current adverse interest, both the potential for a conflict and the perception that there might be a conflict can be sufficient grounds for disqualification.

b. Definition of Actual Conflict

i. An actual conflict of interest has been defined as "an active competition between two interests, in which one interest can only be served at the expense of the other" (see *In re Am. Printers & Lithographers*, 148 B.R. 862, 866 (Bankr. N.D. Ill. 1992)). Whether adverse interests exist is determined on a case-by-case basis (see *In re BH & P, Inc.*, 949 F.2d 1300, 1315-16 (3d Cir. 1998)).

c. Definition of Potential Conflict

i. A potential conflict is said to occur where there is presently no competition between the clients, but it may come into being if certain contingencies take place (see *In re BH & P, Inc.*, 103 B.R. at 563). What was a potential conflict at the beginning of a case may become an actual conflict later on, placing counsel at risk of disqualification. This risk has led some courts to find that a potential conflict is a contradiction in terms (see *In re Kendavis Indus. Int'l, Inc. (In re Kendavis Indus. Int'l)*, 91 B.R. 742, 753-54 (Bankr. N.D. Tex. 1988)).

d. Majority View: Potential Conflicts Require Disqualification

i. The majority view is that the potential for a conflict or the mere appearance of impropriety can constitute a disqualifying conflict of interest (see *In re Interwest Bus. Equip., Inc.*, 23 F.3d 311, 317 (10th Cir. 1994); *In re Martin*, 817 F.2d at 180-81; *In re Consol. Bancshares, Inc.*, 785 F.2d 1249, 1256 n.7 (5th Cir. 1986); *In re Premier Farms L.C.*, 305 B.R. 717; *In re Vebeliunas*, 231 B.R. 181, 191 (Bankr. S.D.N.Y. 1999); *In re Angelika Films 57th Inc.*, 227 B.R. 29; *In re Granite Partners*, 219 B.R. at 33; *In re Leslie Fay Cos., Inc.*, 175 B.R. at 534; *Envirodyne Indus., Inc.*, 150 B.R. 1008 (Bankr. N.D. Ill. 1993); *In re Kendavis Indus. Int'l*, 91 B.R. at 754).

ii. Because section 327(a) of the Bankruptcy Code is designed to limit even the appearance of impropriety, doubt on whether a particular set of facts gives rise to a disqualifying conflict normally is resolved in favor of disqualification (see *In re Angelika Films 57th, Inc.*, 227 B.R. at 39).

e. Minority View: Potential Conflicts May Give Rise to Disqualification in Court's Discretion

i. Some courts take a more flexible approach to disinterestedness by holding that only actual conflicts of interest mandate disqualification. Potential conflicts may lead to disqualification in the exercise of the court's discretion (see *In re Marvel Entm't Grp., Inc.*, 140 F.3d 463, 476 (3d Cir. 1998); *In re Stamford Color Photo, Inc.*, 98 B.R. 135, 137-38 (Bankr. D. Conn. 1989); *In re Waterfall Village of Atlanta, Inc.*, 103 B.R. 340, 344 (Bankr. N.D. Ga. 1989); *In re Oliver's Stores, Inc.*, 79 B.R. 588 (Bankr. D. N.J. 1987)). Like the strict approach, the flexible approach analyzes potential conflicts on a case-by-case basis (see *In re Diamond Mortg. Corp.*, 135 B.R. at 91).

ii. The Third Circuit explained the conflict analysis as follows:

1. Sections 327(a) and (c) of the Bankruptcy Code require disqualification of any attorney who has an actual conflict of interest.

a. The district court:

i. has discretion, under section 327(a) and consistent with section 327(c), to disqualify an attorney who has a potential conflict of interest; and

ii. may not disqualify an attorney on the appearance of a conflict alone. (See *In re Marvel Entm't Grp., Inc.*, 140 F.3d at 476.)

iii. Even under the flexible approach taken by the Third Circuit, potential conflicts and the appearance of impropriety are viewed with extreme caution and the retention of counsel with a potential conflict is disfavored.

f. Examples of Disinterestedness and Adverse Interests

i. A professional's current representation of one or more creditors is more likely to lead to disqualification than a past representation.

1. Attorney who represented a debtor in bankruptcy proceedings while simultaneously being employed by the lender engaged in an unwaivable conflict of interest, requiring the disgorgement of his fee. *Briggs v. LaBarge*, 2006 WL 738172 (8th Cir. March 24, 2006)

ii. Creditor representations on unrelated matters that represent a small percentage of the firm's revenues may be allowed.

iii. A professional that holds outstanding claims for pre-petition fees is disqualified unless the claim is waived.

1. Unpaid Prepetition Fees

a. A professional that has an outstanding claim against the estate is generally not disinterested and is disqualified under section 327(a) of the Bankruptcy Code (§ 101(14)(A), Bankruptcy Code and see *In re Arnold*, 2008 WL 2224932 (Bankr. S.D. Tex. May 27, 2008); *In re Old Summit Mfg., LLC*, 323 B.R. 154, 162 (Bankr. M.D. Pa. 2004)).

b. Waiver of the prepetition claim by the professional typically resolves any conflict arising from the claim (see *In re Metro. Enviro., Inc.*, 293 B.R. 871, 877 (Bankr. N.D. Ohio 2003); *In re Adam Furniture Indus., Inc.*, 158 B.R. 291, 297 (Bankr. S.D. Ga. 1993)).

iv. The prepetition receipt of a retainer generally does not require disqualification.

1. Receipt of Retainer

a. While the receipt of a retainer is not a proper basis for disqualification, to minimize any risk of disqualification or disgorgement, professionals should

disclose retainers existing on the petition date and use them to pay fees only when authorized by the court (see *In re Dearborn Constr., Inc.*, 02−00508, 2002 WL 31941458, at *9 (Bankr. D. Idaho Dec. 20, 2002)). Another precaution is to require the debtor to provide a retainer that is earned by the firm on receipt, such as a classic retainer, if it can be done under the law governing the attorney-client relationship. See *In re Caesars Entm't Operating Co., Inc.*, 561 B.R. 420, 436 (Bankr. N.D. Ill. 2015).

v. The receipt of a potential preference or fraudulent transfer may result in disqualification.
    1. Receipt of Potential Preference or Fraudulent Transfer
        a. The receipt of a potential preferential or fraudulent transfer increases the likelihood of disqualification and may prevent the court from approving a retention even if the professional agrees to return the payments or transfers and waive any related claims (see *In re Pillowtex*, 304 F.3d 246, 255 (3d Cir. 2002); *In re First Sec., Inc.*, 180 F.3d 504, 512 (3d Cir. 1999)). The issue may be neutralized by an investigation by conflicts counsel or an examiner and the agreement of the preference recipient to disgorge the amount that is determined to be avoidable (see *In re Enron Corp.*, 2003 WL 223455, at *9).
        b. To minimize preference risks, bankruptcy professionals seek retainers from a prospective debtor and draw on them during the prepetition period to pay outstanding fees. Fees should be paid in the ordinary course, under agreed terms and methods.

vi. A professional's connection with a target of investigation by the estate may lead to disqualification.
    1. Relationship with Target of Investigation
        a. Professionals with connections to a potential target of investigation for breach of fiduciary duty, fraud, avoidance or similar causes of action have been disqualified (see In re Granite Partners, L.P., 219 B.R. at 37). Courts have approved these retentions based on the debtor's retention of conflicts counsel or by granting derivative standing to the creditors' committee to pursue the investigation (see *In re Caesars Entm't Operating Co., Inc.*, 561 B.R. 420, 435 Bankr. N.D. Ill. 2015)(citing cases).
        b. Although attorney to Chapter 11 debtor-in-possession (DIP) did not appear to have been directly involved in property transfer orchestrated by debtor's principal, whereby principal, after the filing of motion by United States Trustee (UST) to dismiss or convert debtor's Chapter 11 case, caused debtor's chief asset to be transferred to another entity that he controlled in effort to preserve source of income for himself, attorney was duty-bound, once principal consulted attorney about the various responses that he was contemplating in response to the UST's dismissal/conversion motion, to inquire into the details of the responses contemplated and their possible consequences to Chapter 11 estate and its creditors, and to remind principal of his duty to maintain as his paramount concern the interests of Chapter 11 estate and its creditors. *In re Sundance Self Storage-El Dorado LP*, Bkrtcy.E.D.Cal.2012, 482 B.R. 613.

vii. Professionals with strong relationships with insiders of the DIP may be disqualified.
    1. Relationship with Insider of the Debtor
        a. Professionals that have strong relationships with insiders of the debtor may not be disinterested because insiders are often creditors or targets of investigation. Conflicts with insiders typically arise in three situations:
            i. Personal or intercorporate loans guaranteed by an insider.
            ii. The insider is a creditor.
            iii. The DIP is a creditor of or has claims against the insider.
        b. Courts have disqualified professionals that have been paid or guaranteed fees by insiders (see *In re Metro. Enviro., Inc.*, 293 B.R. 871, 885 (Bankr. N.D. Ohio 2003).
            i. In case converted from Chapter 11 to Chapter 7, attorneys for debtor-in-possession (DIP) submitted application for allowance of Chapter 11 compensation and expenses. Creditor objected, and United States Trustee (UST) filed motion to disgorge fees.
            ii. The Bankruptcy Court declined to adopt a per se rule that by accepting a fee guaranty from an insider, an attorney for a corporate debtor creates a conflict of interest that precludes his or her employment under the Bankruptcy Code.
            iii. Pre-conversion fee guaranty executed by DIP's insiders in favor of attorneys created an impermissible conflict of interest and disqualified them from representing DIP, and so their post-guaranty fees and expenses would be disallowed.
            iv. Attorneys' willful disregard of their fiduciary duties by failing to timely disclose the fee guaranty warranted partial, rather than complete, disgorgement of their fees and attorneys would be permanently enjoined from collecting any further fees or expenses from the estate.
            v. Of special concern, is the reality that many small closely-held corporations facing the prospect of bankruptcy do not have the funds available to obtain legal counsel, and therefore must rely upon insiders to finance their legal representation. *See In re Lotus Properties LP*, 200 B.R. 388, 393 (Bankr.C.D.Cal.1996).
            vi. Thus, to adopt a per se rule against insiders providing a fee guaranty could effectively preclude a large class of debtors from seeking bankruptcy protection. As such, a per se prohibition against insiders providing guaranties clearly goes against the bankruptcy policy that, unless a provision specifically provides otherwise, the Bankruptcy Code should be based upon an equitable approach as opposed to hard and fast rules which do not leave any room for crafting an appropriate remedy. *In re Metro. Enviro., Inc.*, 293 B.R. 871, 885 (Bankr. N.D. Ohio 2003).
            vii. In making this determination, the Court finds illustrative the factors set forth in *In re Kelton Motors Inc.*, 109 B.R. 641 (Bankr.D.Vt.1989), which, like the instant case, involved the allowance of an insider's fee guaranty under § 327.
            viii. These considerations are:
                1. the arrangement must be fully disclosed to the debtor/client and the third party payor-insider;
                2. the debtor must give express consent to the arrangement;
                3. the third party payor-insider must retain independent legal counsel and must understand that the attorney's duty of undivided loyalty is owed exclusively to the debtor/client;

4. the factual and legal relationships between the third party payor-insider, the debtor, their respective attorneys, and their contractual arrangement concerning the fees must be fully disclosed to the Court at the outset of the debtor's bankruptcy representation;
5. the debtor's attorney-applicant must demonstrate and represent to the Court's satisfaction the absence of facts that would otherwise create non-disinterestedness, actual conflict, or impermissible potential for a conflict of interest.

c. Other courts have held that an insider's payment of the debtor's retainer or filing fees is not sufficient to render the debtor's law firm not disinterested (see *In re Campbell-Erskine Apothecary, Inc.*, 302 B.R. 169, 175 (Bankr. W.D. Pa. 2003); *In re Missouri Mining, Inc.*, 186 B.R. 946, 948-49 (Bankr. W.D. Mo. 1995)).

d. Even the prior representation of an insider may provide cause for disqualification or denial of compensation where the facts indicate a continuing allegiance to the insider over other estate constituents (see *Rome v. Braunstein*, 19 F.3d 54, 60-61 (1st Cir. 1994); *In re EZ Links Golf, LLC*, 317 B.R. 858, 864 (Bankr. D. Colo. 2004); *In re Angelika Films 57th, Inc.*, 227 B.R. at 40-41).

e. A DIP professional's prior representation of insiders that act as proponents of a Chapter 11 plan does not warrant disqualification provided that the professional:
   i. Adequately discloses the prior representation in its retention application pleadings.
   ii. Is not extensively involved with the insider during pendency of the case.
   iii. Vigorously represents the interests of the estate.
   iv. See *In re Water's Edge L.P.*, 251 B.R. 1, 5-6 (Bankr. D. Ma. 2000).

viii. Professionals with family connections to the DIP may be disqualified.
1. Familial Connections
   a. Professionals related to creditors or other parties in interest may be subject to disqualification (see *In re Ponce Marine Farm, Inc.*, 259 B.R. 484 (D. P.R. 2001)).

VI. Disclosure Obligations

a. Initial Disclosure

i. To meet the requirements of section 327(a) of the Bankruptcy Code for maintaining disinterestedness and holding no adverse interest, Federal Rule of Bankruptcy Procedure 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 trustee, or any person employed in the office of the United States trustee," to the best of the applicant's knowledge.

b. Supplement as needed

i. Professionals to the DIP must supplement their disclosures of connections, as needed, throughout the case (Fed. R. Bankr. P. 2014). The disclosures must be detailed enough to permit the court to determine whether section 327(a) of the Bankruptcy Code has been satisfied (see *Renaissance Residential of Countryside, LLC*, 423 B.R. 848, 857 (Bankr. N.D. Ill. 2010)).

c. Disclosure of Connections Does Not Cure Lack of Disinterestedness

- **i.** Full disclosure of a professional's connections is crucial (see *In re Park-Helena Corp.*, 63 F.3d 877, 880 (9th Cir. 1995)). However, even if a firm's retention is approved for lack of objection or otherwise, there is always the risk that a conflict of interest may surface resulting in the firm's disqualification as debtor's counsel and disallowance of fees, possibly retroactive to the date of retention (see *In re Leslie Fay Cos., Inc.*, 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994)).

d. Connections are Broadly Defined

- **i.** The question of what information rises to the level of relevant information requiring disclosure is unclear and the bar may be lower than expected. Any connection which may be in any way pertinent to a court's determination to retain a professional generally must be disclosed. The bankruptcy court, not professionals, must be in a position to determine whether a prior or current connection with a party in interest rises to the level of an actual conflict or poses a threat of a potential conflict (see *In re Citation Corp.*, 493 F.3d 1313 (11th Cir. 2007); *In re GSC Grp., Inc.*, 502 B.R. 673 (Bankr. S.D.N.Y. 2013)).
- **ii.** These disclosure requirements are broader than the rules governing disqualification. An applicant must disclose all connections regardless of whether they rise to the level of a disqualifying interest under section 327(a). A professional's disclosure obligations continue throughout the case.

e. Examples of Connections that Must be Disclosed

- **i.** Examples of connections that must be disclosed include:
  1. Stock or bond holdings of individuals at the professional firm in the debtor or creditors.
  2. Familial connections with the court or the office of the US Trustee.
  3. The existence of any contractual arrangements between the individual professionals that are working on a case and the professional firm that is being retained (see *In re GSC Grp.*, 502 B.R. 673).
- **ii.** Participation with other professionals on other cases is not a connection that requires disclosure (see *In re eToys, Inc.*, 331 B.R. 176, 195 (Bankr. D. Del. 2005)).

f. Disclosure of Prepetition Compensation and Fee Arrangements

- **i.** Attorneys, whether or not they intend to apply for compensation postpetition, must file a statement within 14 days after entry of the order for relief setting out the amount of compensation paid or agreed to be paid in connection with the case (§ 329(a), Bankruptcy Code; Fed. R. Bankr. P. 2016(b)).
- **ii.** Failure to disclose a fee arrangement under section 329 of the Bankruptcy Code can result in denial of all fees (see *In re Downs*, 103 F.3d 472 (6th Cir. 1996)). If compensation received exceeds the reasonable value of the services, the court may cancel the agreement or order the return of excessive fees (§ 329(b), Bankruptcy Code; see *In re Dean*, 401 B.R. 917 (Bankr. D. Idaho 2008); *In re Whaley*, 282 B.R. 38 (Bankr. M.D. Fla. 2002)).

VII. Consequences of Non-Disclosure

a. Disqualification from employment (see *In re Tinley Plaza Assocs., L.P.*, 142 B.R. 272, 278-80 (Bankr. N.D. Ill. 1992)).

b. Revocation of a prior retention approval order (see *In re Crivello*, 134 F.3d 831, 836 (7th Cir. 1998)).

c. Denial of compensation (see *In re Granite Partners, L.P.*, 219 B.R. 22 (Bankr. S.D.N.Y. 1998)).

i. bankruptcy law firm that failed to disclose actual conflicts of interest must disgorge fees *In re: eToys, Inc.*, 2005 Wl 2456255 (Bankr. D. Del. Oct. 4, 2005),

d. Fraud upon Court

i. *Pearson v. First HN Mortgage Corp.*, No. 98-2207 (1st Cir. Dec. 29, 1999)(attorney's failure to reveal conflicting interests may be fraud on the bankruptcy court).

e. Criminal prosecution (see *US v. Gellene*, 182 F.3d 578, 585-86 (7th Cir. 1999)).

VIII. Corporate Governance & Authority to File

a. Review corporate governance documents

i. What vote is required (percentage) to authorize the filing of a bankruptcy?

ii. Absent approval of board of directors or receiver for Chapter 11 debtor-corporation, director, a 50% shareholder, lacked authority to hire attorney to represent corporation in filing Chapter 11 petition. *In re Gen-Air Plumbing & Remodeling, Inc.*, Bkrtcy.N.D.Ill.1997, 208 B.R. 426.

IX. Withdrawal

a. The lawyer for a bankruptcy estate may not pursue a course of action unless counsel has determined in good faith and as an exercise of professional judgment that the proposed action complies with the Bankruptcy Code and serves the best interests of the estate. *Everett v. Perez (In re Perez)*, 30 F.3d 1209, 1219 (9th Cir. 1994).

b. If counsel for the estate develops material doubts about whether a proposed course of action in fact serves the estate's interests, it must seek to persuade the client to take a different course or, failing that, resign. *Id*.

X. Professional Responsibility Considerations

a. Ohio Rules of Professional Conduct

i. Rule 1.7: Conflict of Interest: Current Clients

1. A lawyer's acceptance or continuation of representation of a client creates a conflict of interest if either of the following applies:
    a. The representation of that client will be directly adverse to another current client;
    b. There is a *substantial* risk that the lawyer's ability to consider, recommend, or carry out an appropriate course of action for that client will be materially limited by the lawyer's responsibilities to another client, a former client, or a third party or by the lawyer's own personal interests.

ii. Rule 1.13: Organization as Client

1. A lawyer employed or retained by an organization represents the organization acting through its constituents. A lawyer employed or retained by an organization owes allegiance to the organization and not to any constituent or other person connected with the organization. The constituents of an organization include its owners and its duly authorized officers, directors, trustees, and employees.

2. If a lawyer for an organization *knows* or *reasonable should know* that its constitution's action, intended action, or refusal to act (1) violates a legal obligation to the organization, or (2) is a violation of law that *reasonably* might be imputed to the organization and that is likely to result in *substantial* injury to

the organization, then the lawyer shall proceed as is necessary in the best interest of the organization. When it is necessary to enable the organization to address the matter in a timely and appropriate manner, the lawyer shall refer the matter to higher authority, including, if warranted by the circumstances, the highest authority that can act on behalf of the organization under applicable law.

3. The discretion or duty of a lawyer for an organization to reveal information relating to the representation outside the organization is governed by Rule 1.6(a) and (c).

4. In dealing with an organization's directors, officers, employees, members, shareholders, or other constituents, a lawyer shall explain the identity of the client when the lawyer *knows* or *reasonably should know* that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

5. A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders, or other constituents, subject to the provisions of Rule 1.7. If the organization's *written* consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization, other than the individual who is to be represented, or by the shareholders.