American Bankruptcy Institute Law Review

Volume 5 Number 2 Winter 1997

Of Grinches, Alchemy and Disinterestedness: The Commission's Magically Disappearing Conflicts of Interest

G. Ray Warner [*]

I. A Christmas Story

Christmas 1997 has come and gone. Santa, in the form of the National Bankruptcy Review Commission, [1] delivered lots of shiny new toys to the children of bankruptcyland. A few got only switches and lumps of coal, [2] and all of the children wondered whether their new toys would really work. [3]

Mary Megafirm had wanted only one thing from Santa. Over the years, she had grown bigger and bigger, and by now she had pretty much outgrown the old professional qualification rules. [4] She had never much liked that nasty and bothersome "disinterestedness" standard, but in recent years the disinterestedness standard was making it harder and harder to play with her Megafirm relatives in the really fun mega−bankruptcies.

Santa received Mary's request very early and assigned several top elves to work on Mary's new toy. The elves threw the old disinterestedness rule on the rubbish heap, and built a lovely new rule that would allow Mary to play in all cases except those where she had a "materially adverse interest." [5] The elves were very proud of the new toy, and some even thought that it was what the Ancestor Elves had actually meant to build back in 1978 when they originally put the disinterestedness rule together. [6]

Unfortunately for Mary, all the commotion attracted a Grinch who did not understand why Mary needed a new rule. [7] The Grinch asked all sorts of bothersome questions like: "Why can't Mary use the same rules by which the other bankruptcy children play?" [8] "If Mary's too big to fit into her old rule, then why doesn't she go on a diet?" [9] and "[t]he bankruptcy playground must be kept cleaner than the other playgrounds; won't Mary's new rule let her roll in too much mud?" [10]

When the elves could not give the Grinch satisfactory answers to those questions, the Grinch stole the new toy from Santa's bag of goodies. The elves were heartbroken. What were they going to give to Mary? With only a little time left before Christmas, they reluctantly retrieved the disinterestedness rule from the rubbish heap and dusted it off. [11] They added a magic bell and a magic whistle to the rule and put it on the sleigh.

On Christmas morning, Mary rushed in to see what Santa had left under her tree. She was crushed. A little while later, she noticed the new bell and whistle. Curious, she rang the bell. Instantly her creditor status was magically transformed from a conflict into no conflict. Then she blew the whistle. Magically her equity security holder status was transformed from a conflict into no conflict. It was not the new rule that she wanted, but at least it was not a lump of coal.

II. A Theory of Magically Disappearing Conflicts of Interest

Mary's gift is reflected in Commission Recommendation 3.3.3. That proposal rejects the Commission's original effort to replace the "disinterestedness" requirement and the "adverse interest" standard of section 327 with a less restrictive "materially adverse interest" standard. [12] Instead, the final recommendation adopts both the current law's disinterestedness definition and the current section 327 adverse interest prohibition as the general standards for

professional employment. It then creates a narrow exception for professionals representing chapter 11 debtors−in−possession. Such professionals would not be disqualified for employment by a debtor−in−possession solely because of an insubstantial unsecured claim or equity interest in the debtor. [13]

The Commission's Recommendation 3.3.3 states:

> Section 1107(b) should be amended to provide that a person should not be disqualified for employment under § 327 solely because such person holds an insubstantial unsecured claim against or equity interest in the debtor. Section 327 and § 101(14) should remain unchanged. [14]

The meaning of that recommendation is amplified in the Commission report discussion of the proposal. The report states:

> The purpose of this change is to facilitate the representation of Chapter 11 debtors when the professional sought to be employed by the debtor holds an unsecured claim against or equity interest in the debtor that is, relative to other claims and interests, insubstantial.
>
> It was determined by the Commission that the purposes of the disinterestedness requirement were not compromised by permitting a debtor in possession to employ professionals who held an unsecured claim against the estate or equity interest in the debtor, so long as that interest was insubstantial in amount in relation to the other claims and interests present in the case. In such circumstances, the interests of the professional are unlikely to diverge substantially from the interests of other creditors and parties. Further, the professional is unlikely to be influenced by such a relatively small claim or equity position in a manner which would sacrifice the interests of the estate to the professional's private interests. It is appropriate to exempt these conflicts from the reach of the disinterestedness requirement. [15]

The Commission's proposal correctly addresses the very real problem that is created by the disinterestedness rule's apparent per se disqualification of professionals for even the slightest creditor or equity interest. [16] However, its proposed solution to the practical problem created by the disinterestedness and adverse interest standards is fatally flawed.

As a practical matter the proposal suffers from only two flaws. The first is that it goes too far. The second is that it does not go far enough.

The proposal is too broad because it defines an "insubstantial" interest from the estate's perspective, rather than from the professional's perspective. Thus, rather than imposing a heightened conflict standard that protects the chapter 11 estate from even the possibility of divided loyalty, the proposal accepts conflicts that would not be permissible even under the generally applicable lawyer ethics rules.

On the other hand, the proposal is too narrow. The cases struggling with de minimis claims and equity interests are merely symptomatic of a deeper problem. The deeper problem is that the absolutist approach of section 327(a) and the section 101(14) disinterestedness definition causes a wide array of de minimis interests to be disqualifying, even though there is little possibility that those interests could influence the professional's judgment. The Commission's theory that an insubstantial *personal pecuniary* interest of the professional poses too small a risk to justify disqualification applies, with even greater force, to an insubstantial conflicting *representational* interest of the professional.

Finally, the Commission's approach is theoretically unsound. Both the Commission's failed attempt to replace the disinterestedness rule, and its final recommendation to modify that rule follow an established tradition in bankruptcy of defining conflicts of interest out of existence, rather than acknowledging and dealing with them. [17] The reality is that conflicts do exist and that they may influence a professional's judgment. While some competing interests truly are so de minimis that they do not rise to the level of a conflict, such conflicts present little problem even under current law. The real problem is presented by those competing interests that are conflicts, but that do not present a great

enough risk to justify the delay, disruption, inefficiency, and expense of disqualifying and replacing the professional. The case law is replete with opinions using those practical factors as the basis for determining that no conflict *exists*. [18] However, rather than being factors that define the *existence* of a conflicting interest, considerations of delay, disruption, efficiency, and expense are factors that should properly be limited to the determination of whether an existing conflict should be *waived*.

III. A Squeaky Clean Bankruptcy System

The current law establishes a very strict prohibition against conflicts by professionals employed by estate entities. [19] A literal reading of the Code's provisions indicates that any conflicting interest is disqualifying, even though it may not constitute an interest that is materially adverse to the estate. [20]

The conflict standards applicable to professionals employed by trustees and chapter 11 debtors in possession are found in several interrelated Code provisions. Under section 327(a), the trustee 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 . . . " [21] The term "disinterested person" is defined in section 101(14). [22] That definition is phrased in the negative, indicating only the types of interests, relationships, and connections that would prevent professionals from being disinterested −− and thus render the professional ineligible for employment under section 327(a). Subsections (A) through (D) of the provision list specific relationships that are disqualifying. [23] The provisions are described as establishing a "prophylactic" rule because they identify certain types of interests that are deemed to pose such a great risk that they result in per se disqualification. Those are followed by subsection (E), which is a "catch−all" provision that disqualifies persons who have "an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders" for any reason. [24]

The combined requirements of being disinterested and of not holding or representing an interest adverse to the estate appear to create an absolute bar against any conflicting interest of trustee−employed professionals. [25] These strict anti−conflict standards are applied to professionals employed by a chapter 11 debtor−in−possession through section 1107(a). [26]

Several reasons are cited by the courts and commentators in support of the rigid [27] anti−conflict rule in bankruptcy cases.

The first is the unique nature of the bankruptcy process. [28] Both a trustee and a debtor−in−possession owe fiduciary obligations to the estate and to the creditors. [29] In addition, in a bankruptcy proceeding many parties are not represented and must depend upon the integrity of the process to protect their interests. [30] As the Commission Report notes, "[s]trict disinterestedness standards are necessary because of the unique pressures inherent in the bankruptcy process." [31] The second reason is the need to preserve public confidence in the bankruptcy system. [32] As the Commission Report states, "[t]here must always be vigilance to ensure that the public has confidence in the bankruptcy system's fairness and that it is operating to the public benefit, not just to enrich debtors and their professionals." [33] Historically, a lack of confidence in the integrity of the bankruptcy system has been the trigger for many of the efforts at bankruptcy reform. [34] Thus, although the generally applicable lawyer ethical rules have moved away from the "appearance of impropriety" standard, [35] that standard remains firmly entrenched in bankruptcy because of the "congressional intent to eliminate not only all conflicts of interest but also any appearance of impropriety." [36]

The final reason parallels the policy behind the generally applicable conflict of interest standards found in the lawyer ethics rules. Just like the ethical conflict rules, the bankruptcy conflict rules are designed to ensure that the professionals devote undivided loyalty to the trustee or debtor−in−possession. [37] However, although the bankruptcy conflict rules parallel the ethical conflict rules, they do not purport to replace them. [38] Thus an attorney representing a trustee or debtor−in−possession must satisfy both the section 327(a) standards and the applicable state ethical rules. [39]

IV. The Theory Meets Reality

The section 327(a) standards operate much like an on/off switch. Once the court finds an adverse interest or determines that the professional is not disinterested, the professional may not be employed by the trustee or debtor−in−possession. [40] Further, even if the employment is otherwise necessary or appropriate to administer the bankruptcy case, the bankruptcy court has no power to vary or waive the standards set by section 327(a) and section 101(14). [41] However, these theoretical limitations have presented little difficulty to those courts seeking a practical solution to the problems created by the conflict rules. Thus, the bankruptcy courts regularly permit the employment of interested professionals in cases where the interest is de minimis or where the benefits of employing the interested professional clearly outweigh the risk of divided loyalties.

However, rather than engaging in an honest evaluation of whether competing considerations justify the waiver of a conflict, the section 327(a) rules force the courts to pretend that they are instead determining whether the conflict exists. Since the bankruptcy court has no power to waive a conflict, it must instead define the conflict out of existence if it wishes to approve the professional's employment. This has resulted in a hopelessly confused body of case law and has produced many tortured interpretations of the existing rules. The result is that the apparently clear provisions of the Code have no uniformly applied meaning and the policy goals that those provisions were designed to advance are subject to the whims of the particular judge. [42]

Evidence of this distortion of the rules can be found in the major lines of case authority on professional qualification issues.

For example, the issue addressed by the Commission's proposal is whether the professional's creditor or equity security holder status is disqualifying. [43] The answer under the plain language of section 101(14)(A) is that the professional clearly is disqualified. Many cases apply this per se disqualifying rule. [44] Professionals wishing to represent the debtor−in−possession in those jurisdictions must waive their prepetition fees in order to become qualified. [45] However a competing line of authority recognizes an exception to the rule in cases where the professional's creditor or equity interest can be described as de minimis. [46] Not surprisingly, although the dictionary defines de minimis as "very small or trifling matters," [47] the courts adopting the de minimis exception frequently incorporate considerations of delay, disruption, efficiency, and expense into their analysis. [48] Thus bankruptcy courts, under the pretext of deciding what is small or trifling, are actually weighing whether practical considerations justify a waiver of the disinterestedness rule.

A similar distortion of theory appears in cases dealing with the § 101(14)(D) per se disqualification of persons who have been officers of the debtor within two years prior to bankruptcy. The problem is presented by attorneys who served as corporate secretary for the prepetition debtor. Although the attorney typically assumed that role for the convenience of the debtor and usually has not had the type of dealings with the debtor that would present a conflict of interest, the disinterestedness definition appears to disqualify her from representing the debtor−in−possession. [49] Nonetheless, several courts have found ways to avoid that prohibition by distinguishing between the "person" of the individual lawyer and the "person" of the law firm. [50] Relying on the imputed conflict principles of the lawyer ethics rules, these cases hold that the disqualification of the lawyer is not imputed to the law firm as long as an "ethical wall" is erected to separate the tainted lawyer from the case. [51] Skepticism about the basic premise of the per se disqualification rule for corporate secretaries plays a role in these decisions, and the courts' reliance on imputed conflict principles demonstrates that they are attempting to evaluate the *extent* of the relationship under the guise of applying the definition of the *type* of disqualifying relationship. [52] Further, although the inquiry is ostensibly a definitional exercise, the courts once again incorporate considerations of delay, disruption, efficiency, and expense into their analysis. [53]

A final example comes from the cases interpreting the adverse interest and materially adverse interest standards. Here again the problem is that in theory a conflict once found is disqualifying. However, the courts have found a way around the apparently rigid rules. Many cases draw a distinction between a "potential" conflict and an "actual" conflict and assert that only an actual conflict is disqualifying. [54] Much judicial energy is then spent trying to distinguish one from the other. However, rather than focusing merely on the question of whether the conflict is ever likely to arise, the cases instead incorporate considerations of delay, disruption, efficiency, and expense into their analysis. [55] A competing line of authority rejects the distinction and requires that the professional be "divested of any scintilla of personal interest which might be reflected in his decision concerning estate matters." [56]

While it may be possible to find competent professionals without any scintilla of conflicting interest, [57] the case law, [58] common sense, [59] and even the Commission's proposal suggest that some conflicts must be accepted. [60] Those conflicts are accepted not because Congress was wrong in its initial determination that the particular type of interest, relationship, or connection created a risk of divided loyalty, but because the cost of disqualification to the system and to the parties greatly outweighs the risk posed. [61] Any attempt to amend the rules should focus on the central issue −− the cost−benefit analysis. The Commission's proposal to define away two types of conflicting interests fails to address the real problem presented by the current rules.

V. The Proposal Does Not go Far Enough

To its credit, the Commission's proposal to eliminate the per se disqualification of professionals for "insubstantial" claims or equity interests will help resolve a minor, but troublesome problem created by the current rules. [62]

The debtor−in−possession frequently will have a long−standing prepetition relationship with professional firms and will wish to retain those same professional firms after filing chapter 11. [63] Although the retention of prepetition professionals raise some conflict problems, section 1107(b) clearly authorizes the practice. [64] However, since the prepetition professionals may be owed fees for prepetition services, section 327(a) and the per se disqualification of creditors under section 101(14)(A) appear to disqualify such professionals. [65] Professionals could avoid disqualification by waiving their prepetition fees. [66] Alternatively, they could rely on the de minimis exception to section 101(14) [67] or on case law creating an exception for fees earned "in contemplation of or in connection with the case." [68] The Commission's proposal carves out a broader exception that is not limited to fees incurred in contemplation of bankruptcy, or even to fee claims. [69] It should resolve the prepetition fee controversy and eliminate the need for professionals to engage in elaborate prepetition fee protection strategies. [70]

The Commission's proposal to exempt "insubstantial" equity interests addresses a problem that has not yet become significant. [71] At least for publicly traded companies, strict application of the equity security holder rule is potentially a greater problem than the professional's creditor status. Since it is highly likely that partners in the large professional firms hold at least some stock in almost any publicly traded debtor, it is curious that only a few cases even discuss the problem of stock holdings by members of a professional firm. [72] Presumably these issues are either not being disclosed to the courts or they are being handled under the de minimis exception without published opinions. [73] The problem is complicated by the growth of mutual funds as an investment vehicle. [74] Not only does mutual fund investing increase the likelihood that firm members will have a financial interest in the debtor, but it generally deprives the firm member of the ability to make a full disclosure. [75] The Commission's proposal prevents this issue from developing into a significant disqualification problem. [76] However, its absolutist approach may not be the best way to address the unique issues raised by mutual funds. [77]

The Commission's decision to limit its proposal to chapter 11 debtors−in−possession overlooks the fact that the per se disqualification of creditors and equity security holders may affect trustees and official committees as much as it affects debtors. [78] Although the focus of the case law and commentary has been on the problems that a prepetition fee claim creates for debtors−in−possession, [79] imputed disqualification of a professional firm because of a firm members' stock holdings could deprive a chapter 7, or chapter 11 trustee or an official committee of competent professional assistance. [80]

While the Commission's proposal partially addresses the problem raised by the insubstantial claims and equity interests, [81] it treats only the symptom and ignores the disease. The real problem, of which the creditor and equity interest cases are only a symptom, is the Code's per se approach to disqualification. [82] That approach causes a wide range of de minimis interests to be disqualifying, even when there is no possibility that the particular interest could influence the professional's judgment. [83] It also leaves no room for the courts to balance the risk of divided loyalty against the practical interests and needs of the bankruptcy system.

The Commission's theory for exempting the professional's own claims and equity interests is that "the professional is unlikely to be influenced by such a relatively small claim or equity position in a manner which would sacrifice the interests of the estate to the professional's private interests." [84] If it is correct that an insubstantial *personal pecuniary* interest of the professional does not compromise the purposes behind the disinterestedness requirement, [85] then the

Commission's reasoning should apply with greater force to an insubstantial conflicting *representational* interest of the professional. [86] The most pernicious of conflicts are those where the professional's personal interests conflict with her professional duties. [87] Yet, out of the universe of possible insubstantial conflicts, the Commission has blessed only those with the greatest potential for affecting the professional's judgment.

Furthermore, while the Commission's theory supports an extension of the exception to other types of insubstantial conflicts, the needs of the bankruptcy system compel it. [88] The recent trend towards the consolidation of accounting firms provides an excellent example of the pressures that the disqualification rules will face in the future. [89] Since the remaining large national accounting firms have extensive client lists and offer a variety of consulting services in addition to traditional accounting services, [90] it is highly likely that representational conflicts may disqualify *all* firms capable of handling a large estate's business.

Finally, the proposal may take away more than it gives. On a wide range of interest and conflict issues, the flexibility that the bankruptcy system needs in order to accomplish its objectives has been provided by judicial decisions that create non−statutory exceptions to the strict per se disinterestedness and adverse interest rules. By blessing only two types of insubstantial interests, and by limiting that blessing to chapter 11 debtors−in−possession, the proposal rejects those exceptions and reaffirms the per se rule for all remaining situations. [91]

VI. The Proposal Goes Too Far

The Commission's approach of defining away certain types of conflicts caused it to lose sight of the central purpose of the professional qualification rules. That purpose is to ensure that the professionals exercise independent professional judgment free from conflicting influences. [92] In its effort to address the problems presented by the per se disqualification of creditors and equity security holders, the Commission adopted a proposal that accepts conflicts that would not be permissible even under the generally applicable attorney ethics rules. [93]

In defining the categories of creditor and equity interests that are not disqualifying the Commission's proposal does not merely adopt the de minimis line of cases. It goes beyond the exemption of those interests that are too trivial to qualify as real conflicts of interests and exempts all creditor and equity interests that are "insubstantial." While that alone causes the proposal to define away some real conflicts of interest, the Commission's definition of an insubstantial interest presents a more serious problem. Rather than measuring whether the interest is substantial from the professional's perspective, the proposal defines an insubstantial interest from the estate's perspective. Thus, the professional's claim or equity security interest is not disqualifying "so long as that interest was insubstantial in amount in relation to the other claims and interests present in the case." [94]

Since the focus of the disqualification inquiry should be on the question of whether the professional's exercise of professional judgment is likely to be influenced by the professional's own interests, the only proper way to measure whether the claim or equity interest is substantial is to explore the issue from the professional's perspective. [95] The question is whether the professional might be influenced by the claim or equity interest, [96] and not whether it is a large claim or equity interest from the estate's perspective. Even a small claim or equity interest should be disqualifying if it represents a substantial portion of the professional's net worth. [97]

In the larger bankruptcy cases, the Commission's proposal effectively eliminates the creditor and equity security holder provisions of the disinterestedness definition. In a mega−case, the professional's claim or equity interest will never be large enough to trigger application of the rule. [98] Even in a case of modest size, it would be highly unlikely that the professional's claim or equity interest would be large enough to be substantial in relation to the size of the other claims or interests in the case.

Further by amending section 1107(b) instead of section 101(14), the proposal arguably removes all insubstantial claims and equity interests from bankruptcy court scrutiny. The proposed statutory language of section 1107(b) reads, "Notwithstanding section 327(a) . . . , a person is not disqualified for employment
. . . by a debtor in possession solely because of such person's being the holder of an insubstantial unsecured claim against or equity interest in the debtor." [99] Of course section 327(a) is the only source of a standard for disqualification. [100] That section sets forth the adverse interest standard and it incorporates the section 101(14)(E)

materially adverse interest standard by reference. Other than an occasional and largely irrelevant limitation such as the section 327(f) provision that prohibits the employment of a person who served as an examiner, there are no other disqualification standards. Thus, the plain language of the amendment [101] would not permit disqualification even if the insubstantial creditor or equity interest constituted a materially adverse interest. [102]

Even without this problem, the Commission's proposal goes too far because it defines away conflicting interests that pose a serious risk of compromising the integrity of the debtor−in−possession's professionals. The only interests that should be excluded from the conflict analysis are those that are of too little importance to the professional to have the potential to influence her actions. Of course such a limitation would bring the analysis full circle. Presumably the only claims that are of such little importance to the professional that they should be ignored are those that the professional would have been willing to waive in order to represent the debtor−in−possession.

VII. A Waiver Model is Preferable

Practical concerns aside, the Commission's approach is theoretically unsound. Either no conflicts of any type should be permitted, or some conflicts should be accepted. The Commission has decided correctly that some conflicts must be accepted in order for the bankruptcy process to function. [103] Unfortunately the Commission's thinking did not break out of the structure of the existing rules.

Although the case law has blurred the rules, the current statutory provisions basically set forth prophylactic rules that define the *types* of interests, relationships and connections that present an unacceptable risk of conflict, without regard to the *extent* of the conflict or to other countervailing factors. Since there can be no exercise of discretion, such rules are properly drafted as per se disqualifications based solely on the type of interest, relationship, or connection.

The Commission's proposal, on the other hand, is designed to allow some conflicts of interest. A rule that allows conflicts based on type alone provides no mechanism for ensuring that the goals of the conflict rule are met. The proper balance between the need to ensure professional loyalty and the practical realities of bankruptcy practice can only be achieved by a discretionary rule that considers both the *extent* of the conflict and the countervailing factors.

The structure of the current statutory provisions caused the Commission to identify section 101(14)(A) as the problem, because that section took the creditor and equity interest *types* of relationships and defined them into the per se conflict rule. The obvious, but wrong solution, was to define those types of relationships back out of the conflict rule.

What the Commission failed to realize is that removing creditor and equity interests from the per se disqualification rule is only the first step. Once the decision is made to permit any conflicting interest in bankruptcy representation, the focus of the analysis should shift to the standards that the court should employ to evaluate whether to approve the employment of the conflicted professional. On that issue, the Commission's proposal is silent.

The problem of deciding when to accept a conflict is not unique to bankruptcy practice. In the non−bankruptcy arena, it is not necessary to define the conflict out of existence. Instead, the conflict can be acknowledged and then dealt with through client consent and waiver. [104] The factors of delay, disruption, efficiency, and expense are among the considerations that might go into the client's cost/benefit analysis in deciding whether to approve a waiver.

A similar model should be adopted in bankruptcy. While a limited list of per se disqualifying interests, relationships, and connections may be appropriate, all other conflicts should be dealt with through court−approved waivers. If a higher conflict of interest standard is desired in bankruptcy cases, it could be accomplished through the simple device of adjusting the standard of court review. For example, instead of granting the court authority to approve waivers based on the "business judgment" test, [105] approval could be limited to cases where the balance of the relevant factors "clearly favors" approval, [106] or even to a narrower class of cases where the trustee, official committee, or debtor−in−possession is "unable to obtain" the services of a non−conflicted professional. [107]

The fatal flaw in the Commission's proposal is that it continues the current approach of defining conflicts out of existence, much like Mary's bell and whistle. What is needed by the bankruptcy system is a more honest waiver model that can accommodate the changes in professional practice and that keeps the focus where it ought to be¾ on the

question of whether a particular conflict poses sufficient risk to justify disqualification.

Epilogue

Mary soon discovered something curious about her new bell and whistle. They weren't really magic after all. They did not make her conflicts disappear. The conflicts only seemed to disappear because everyone in bankruptcyland pretended not to see them.

FOOTNOTES:

[*] Professor of Law, University of Missouri−Kansas City School of Law, Kansas City, Missouri. The author thanks his research assistant, Walter Pirnot, for his invaluable assistance in preparing this article for publication.Back To Text

[1] The National Bankruptcy Review Commission was established by Congress to review the bankruptcy laws and make recommendations for necessary reforms. Bankruptcy Reform Act of 1994, Pub. L. No. 103−394, § 603, 1994 U.S.C.C.A.N. (108 Stat. 4107) 4147. *See generally* Nat'l Bankr. Rev. Comm'n, Bankruptcy: The Next Twenty Years, Final Report 47 (1997) [hereinafter Commission Report]. Back To Text

[2] For example, the Commission rejected the credit card lenders' proposals to require that consumer debtors be forced to pay a greater amount of their debts. *See* Saul Hansell, *Battle Emerging on How to Revise Bankruptcy Law*, N.Y. Times, Oct. 19, 1997, at A1 (stating banks and credit card lenders want consumers to pay larger amounts of their debts).Back To Text

[3] *See* id. (quoting Senator Grassley, "I don't think that Congress will be guided by [the recommendations of the Commission]"); *see also* Paul Wiseman, *Bankruptcy Plan Rejected, But Reform is Coming*, USA Today, Oct. 21, 1997, at A1.Back To Text

[4] Bankruptcy is becoming a large firm practice and those firms are inherently more subject to conflicts in debtor representation. *See* Jay Lawrence Westbrook, Fees and Inherent Conflicts of Interest, 1 Am. Bankr. Inst. L. Rev. 287, 288 (1993). Back To Text

[5] *See* Memorandum from Lawrence P. King & Elizabeth I. Holland to the National Bankruptcy Review Commission 1 (Aug. 22, 1996) (on file with the *American Bankruptcy Institute Law Review*) [hereinafter Memorandum] (proposing deletion of disinterestedness requirement for professionals, but suggesting retention of "materially adverse interest" standard). This "materially adverse interest" standard tracked a proposal by the American Bar Association. *See* Gerald K. Smith, *Disinterestedness*, Ann. Surv. of Bankr. L. 639, 644 (1995−96) (explaining American Bar Association's recommendation for section 327(a) proposed use of materially adverse interest test). *But see* Commission Report, supra note 1, at 871 (explaining Commission rejected "First Proposal" to eliminate disinterestedness requirement and, instead, chose to retain general requirement of disinterestedness while adding "specific and narrowly−tailored remedies aimed at specific problems"). Back To Text

[6] The Memorandum argues that application of the disinterestedness standard to debtor−in−possession professionals resulted from a drafting error in the 1978 Code. *See* Memorandum, *supra* note 5, at 3; *see also* Richard Lieb, *The Section 327(a) "Disinterestedness" Requirement − Does a Prepetition Claim Disqualify an Attorney for Employment by a Debtor In Possession?*, 5 Am. Bankr. Inst. L. Rev. 101, 106 (1997) (explaining drafting error in 327(a) wrongfully caused disinterestedness requirement to apply to debtors−in−possession).Back To Text

[7] Commissioner Hon. Edith H. Jones said, "[b]y doing away with disinterestedness, we are essentially using a sledge hammer to swat a fly." *Bankruptcy Reform: Consumer, Small Business, Proposals Adopted by Commission in Detroit*, BNA Bankruptcy Law Daily, July 16, 1997, at 3, *available in* LEXIS, BNABLD.Back To Text

[8] Commissioners Jones and James I. Shepard believed that the original proposal "would benefit large national firms who seek to obtain representation of multiple parties in the face of declining Chapter 11 filings, and that the problems faced by those firms do not merit the commission's attention." *Bankruptcy Reform: Review Commission Begins to*

Close in on Final Votes as October Home Stretch Beckons, BNA Bankruptcy Law Daily, June 11, 1997, at 3, *available in* LEXIS, BNABLD. Back To Text

[9] Commissioner Jones said "she doesn't 'have a lot of sympathy' for the very big firms who have lawyers representing the debtor on one floor of the building and lawyers representing its creditors on another. 'This is not acceptable.'" Id.Back To Text

[10] *See* Commission Report, *supra* note 1, at 874−79 (comments by Commissioner Edith H. Jones) (summarizing Commission's reasons and conclusions for Recommendation 3.3.3). Back To Text

[11] *See id.* at 870−71 (noting how original vote to eliminate disinterestedness standard was reconsidered and reversed by 7−2 vote in July 1997). Back To Text

[12] *See* id. (relating Commission's initial construction of "materially adverse standard" and subsequent rejection thereof).Back To Text

[13] The proposal would make no changes to the section 101(14) "disinterestedness" definition and it would leave unchanged the section 327(a) requirements that the professional be a "disinterested person" and "not hold or represent an interest adverse to the estate." As amended, the new section 1107(b) would read:

> (b) Notwithstanding § 327(a) of this title, a person is not disqualified for employment under § 327 of this title by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case, or solely because of such person's being the holder of an insubstantial unsecured claim against or equity interest in the debtor.

Id. at 881 (additions underlined in original).Back To Text

[14] *Id.* at 869.Back To Text

[15] Commission Report, *supra* note 1, at 881−82. Back To Text

[16] *See generally id*. at 881 (noting elimination of disinterestedness rule would not lead to uniform application in case law).Back To Text

[17] *See id.* at 881−83 (discussing recommended changes to 11 USC § 1107(b)).Back To Text

[18] *See, e.g.,* In re Martin, 817 F.2d 175, 182 (1st Cir. 1987) (stating that inquiry into disinterestedness must be case specific); United States Trustee v. PHM Credit Corp. (In re PHM Credit Corp.), 110 B.R. 284, 289 (E.D. Mich. 1990) (allowing retention of law firm, even though not technically disinterested, because adding counsel would cost up to one million dollars).Back To Text

[19] *See* Commission Report, supra note 1, at 874; *see also* Pierson & Gaylen v. Creel & Atwood (In re Consolidated Bancshares, Inc.), 785 F.2d 1249, 1256 n.6 (5th Cir. 1986) (stating "standards for the employment of professional persons are strict . . . in light of the unique nature of the bankruptcy process") (citing *In re* Cropper Co., 35 B.R. 625, 629 (Bankr. M.D. Ga. 1983)). Back To Text

[20] *See* Commission Report, supra note 1, at 872. The Commission notes that case law requires the applicant "have *no* interest adverse to the estate regardless of materiality." Id. (emphasis in original). See also R. Craig Smith, Note, Conflicts of Interest Under the Bankruptcy Code: A Proposal to Increase Confidence in the Bankruptcy System, 8 Geo. J. Legal Ethics 1045, 1047−48 (1995), discussing how the Bankruptcy Code emphasizes the need to protect the integrity of the bankruptcy process through more stringent conflict of interest rules than provided by the ABA's Model Rules of Professional Conduct. Interestingly, although much of the literature criticizes the strict disinterestedness standard, bankruptcy professionals generally support the existing standards. *See* American Bankruptcy Institute, American Bankruptcy Institute Report on the State of the American Bankruptcy System 9 (G. Ray Warner rep. 1996).

A majority of professionals surveyed, supported disqualification where the attorney has received a potentially avoidable prepetition transfer, represents an affiliate or principal of the debtor, represents a creditor in an unrelated matter, and where the attorney, or another lawyer in the firm, previously served on the debtor's board of directors. *See* id. However, two−thirds of the respondents supported an amendment that would permit the attorney to be employed even though she was owed prepetition fees. *See* id.Back To Text

[21] 11 U.S.C. § 327(a) (1994). Although the section 327(a) standards are not expressly incorporated into the section 1103(b) provision governing professionals employed by official chapter 11 committees, the courts have relied upon section 328(c) to apply the disinterestedness standard to committee−employed professionals. *See* In re Caldor, Inc., 193 B.R. 165, 170−71 (Bankr. S.D.N.Y. 1996). The *Caldor* court reads section 328(c) to require denial of compensation for any professional person if at any time during her employment she is not a disinterested person. *See* id. This is based on the language of section 328(c), which authorizes the court to deny compensation to professionals employed under section 327 or section 1103 if such professional person "is not disinterested person or represents, or holds an interest adverse to the interest of the estate . . . " 11 U.S.C. § 328(c). Back To Text

[22] Section 101(14) states:

> (14) "disinterested person" means a person that−−
>
> (A) is not a creditor, an equity security holder, or an insider;
>
> (B) is not and was not an investment banker for any outstanding security of the debtor;
>
> (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;
>
> (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;

11 U.S.C. § 101(14).Back To Text

[23] *See* id. *Back To Text*

[24] Id.Back To Text

[25] The disinterestedness definition is "broad enough to include anyone who in the slightest degree might have some interest or relationship that would even faintly color the independent and impartial attitude required by the Code and Bankruptcy Rules." In re Philadelphia Athletic Club, Inc., 20 B.R. 328, 334 (E.D. Pa. 1982); *accord* In re BH & P, Inc., 949 F.2d 1300, 1308 (3d Cir. 1991); Pierson & Gaylen v. Creel & Atwood (In re Consolidated Bancshares, Inc.), 785 F.2d 1249, 1256 (5th Cir. 1986).Back To Text

[26] The Commission's original proposal was based in part on the theory that the incorporation of the disinterestedness standard into section 1107(a) was a drafting error. *See* Memorandum, supra note 5. The Commission's final report expressly rejects the argument that section 1107 resulted from a drafting error. *See* Commission Report, supra note 1, at 880 (noting application of disinterestedness to debtors−in−possession was intentional congressional choice).Back To Text

[27] The bankruptcy conflict of interest rules are stricter than the generally applicable lawyer ethical standards. *See* Rome v. Braunstein, 19 F.3d 54, 57 (1st Cir. 1994) (discussing particularly rigorous conflict of interest restraints in bankruptcy context); In re Diamond Mortgage Corp., 135 B.R. 78, 90 (Bankr. N.D. Ill. 1990) (noting conflict of interest rules more strictly applied in bankruptcy context than other areas of law).Back To Text

[28] *See* Consolidated Bancshares, Inc., 785 F.2d at 1256 n.6 (noting unique nature of bankruptcy process) (citing *In re* Cropper Co., 35 B.R. 625, 629 (Bankr. M.D. Ga. 1983)).Back To Text

[29] *See* Interwest Bus. Equip., Inc. v. United States Trustee (In re Interwest Bus. Equip., Inc.), 23 F.3d 311, 316, n.9 (10th Cir. 1994) (noting fiduciary responsibilities).Back To Text

[30] *See* In re Vanderbilt Assoc., 111 B.R. 347, 352 (Bankr. D. Utah 1990) (recognizing need to protect society and noting specific restriction imposed by Congress to make bankruptcy courts more active in regulation of attorneys), rev'd on other grounds, 117 B.R. 678 (D. Utah 1990).Back To Text

[31] Commission Report, supra note 1, at 874. The report also supports a higher conflict standard on the twin grounds that it is the creditors' money that is used to fund the reorganization and that the professional is "required to act as a fiduciary for the estate, its creditors, other parties in interest, and the court, and not solely as the trustee's advocate." Id. The report goes on to assert that "an even stricter adherence to disinterestedness may be appropriate for the debtor−in−possession's professionals than for those of a disinterested trustee" because of the debtor−in− possession's inherent conflicts of interest. Id. at 875.

Although conflict−free representation is more important when the client is a fiduciary, the Commission is incorrect in its assertion that the representation of a fiduciary imposes similar fiduciary duties on the attorney. *See* ABA Comm. on Ethics and Professional Responsibility, Formal Op. 94−380 (1994). Back To Text

[32] *See* Diamond Mortgage, 135 B.R. at 90 (discussing two major reasons for strict conflict of interest rules in bankruptcy cases). The strict section 327(a) standards also reflect Congress' concern about perceived past abuses. *See* S. Rep. No. 95−989, at 40 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5826 (noting many "sordid chapters" in the history of professional employment in bankruptcy). Back To Text

[33] Commission Report, supra note 1, at 875.Back To Text

[34] "The problems caused by the combination of administrative and judicial responsibility for the case, the lack of true creditor control, and the cronyism of the 'bankruptcy ring' are not new. They have plagued the bankruptcy system for many years. The Bankruptcy Commission documented them in detail in its study, and noted their persistence in the bankruptcy system for over forty years." H.R. Rep. No. 95−595, at 96 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6057. The House Report then quotes the Commission's Donovan Report, which includes the following statement, "[T]he administration of the bankruptcy law was characterized by serious abuses and malpractices on the part of attorneys, receivers, trustees, appraisers, custodians, auctioneers, and other persons and associations." Id. Back To Text

[35] Charles W. Wolfram, Modern Legal Ethics § 7.1.4, at 319−23 (student ed. 1986) (noting shift away from appearance of impropriety standard).Back To Text

[36] In re Intech Capital Corp., 87 B.R. 232, 235 (Bankr. D. Conn. 1988). *See also* Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir. 1994) (discussing appearance of impropriety). For this reason, criticism of the bankruptcy courts' continued use of appearance of impropriety standard misses the mark. *See* Michel v. Federated Dep't Stores, Inc. (In re Federated Dep't Stores, Inc.), 44 F.3d 1310, 1319 (6th Cir. 1995) (interpreting congressional intent to disqualify professionals with appearance of conflict as well as actual conflicts). *But see* In re BH & P Inc., 949 F.2d 1300, 1310 (3d Cir. 1991) (rejecting appearance of impropriety standard).Back To Text

[37] *See* Rome, 19 F.3d at 58; *see also* In re Martin, 817 F.2d 175, 180 (1st Cir. 1987) (stating bankruptcy court has responsibility to ensure that disinterestedness requirement is heeded).Back To Text

[38] *See* Vergos v. Timber Creek, Inc., 200 B.R. 624, 628 (W.D. Tenn. 1996) (stating that state's professional ethics code requiring law firm's disqualification is independent question); *see also* In re Glenn Elec. Sales Corp., 99 B.R. 596, 598 (D. N.J. 1988) (stating that bankruptcy courts apply ABA rules in New Jersey when reviewing motion to disqualify attorney); In re O'Connor, 52 B.R. 892, 899 (Bankr. W.D. Okla. 1985) (applying Oklahoma Code of Professional Responsibility); *cf.* In re Diamond Mortgage Corp., 135 B.R. 78, 89 (Bankr. N.D. Ill. 1990) (stating that section 327 implies that professional must live up to requirements of appropriate codes of conduct) .Back To Text

[39] *See* Diamond Mortgage, 135 B.R. at 89 (commenting on implied additional requirements under section 327(a)). Back To Text

[40] *See* Federated Dep't Stores, 44 F.3d at 1318 (concluding that prohibition is unambiguous). Back To Text

[41] The bankruptcy court cannot use its general equitable powers under section 105 to override the express requirements of section 327(a). *See* United States Trust v. S.S. Retail Stores Corp. (In re S.S. Retail Stores Corp.), 211 B.R. 699, 703 (B.A.P. 9th Cir. 1997) (stating court cannot waive section 327(a) requirements); Diamond Mortgage, 135 B.R. at 90 (discussing rationale for non−waiver of section 327(a)); *cf.* In re Saxon Indus., 29 B.R. 320, 322 (Bankr. S.D.N.Y. 1983) (noting no power to waive section 1103(b)); Regina S. Kelbon et al., *Conflicts, The Appointment of "Professionals," and Fiduciary Duties of Major Parties in* Chapter 11, 8 Bankr. Dev. J. 349, 357 (1991) (citing Childress v. Middleton Arms, Ltd. Partnership (In re Middleton Arms, Ltd. Partnership), 119 B.R. 131, 134 (M.D. Tenn. 1990) (6th Cir. 1991) (reversing decision authorizing employment of all interested real estate brokers if creditors and equity security holders would benefit)), aff'd, 934 F.2d 723. Back To Text

[42] The splits reflected in the published opinions may represent only the tip of the iceberg. Although there are no data on the actual incidence of applying relaxed conflict standards, the data that exist on disqualification practices suggest that the published cases reflect a stricter view of the rules than is the actual practice of the bankruptcy courts. *See* American Bankruptcy Institute, American Bankruptcy Institute National Report on Professional Compensation in Bankruptcy Cases, § 1 at 2 (G. Ray Warner rep. 1991). For example, in the 1991 study of professional compensation practices, 86 percent of the bankruptcy judges surveyed indicated that they permitted debtor's counsel to receive prepetition retainers or guarantees from third parties, even though case law suggests a more restrictive view. *See* id. § 6.2 at 92−93.Back To Text

[43] *See* Merrimac Assoc. v. Daig Corp. (In re Daig Corp.), 799 F.2d 1251, 1253 (8th Cir. 1986) (holding warrants as equity security interest resulting in disqualification).Back To Text

[44] *See, e.g.,* Electro−Wire Prod., Inc. v. Sirote & Permutt, P.C. (In re Prince), 40 F.3d 356, 361 (11th Cir. 1994) (disqualifying law firm though it was owed relatively "small" amount by debtor); United States Trustee v. Price Waterhouse, 19 F.3d 138, 141 (3d Cir. 1994) (stating debtor−in−possession cannot retain prepetition creditor to assist in execution of its Title 11 duties); Pierce v. Aetna Life Ins. Co. (In re Pierce), 809 F.2d 1356, 1362 (8th Cir. 1987) (noting creditor status disqualifying).Back To Text

[45] *See* Patti Williams, Comment, Bankruptcy Code Section 327(a) – New Interpretation Forces Attorneys to Waive Fees or Waive Good−Bye to Clients, 53 Mo. L. Rev. 309, 321 (1988) (stating attorney must waive prepetition debts at outset of case so attorney will be eligible for employment under 327(a)).Back To Text

[46] *See, e.g.,* In re Viking Ranches, Inc., 89 B.R. 113, 114−15 (Bankr. C.D. Cal. 1988) (holding $21,025 claim de minimis); In re O'Connor, 52 B.R. 892, 899 (Bankr. W.D. Okla. 1985) (holding 1000 shares out of 12,969,626 de minimis); *cf.* Blackmon v. Runyan (In re Runyan), 832 F.2d 58, 60 (5th Cir. 1987) (stating $600 to $800 worth of claims too large to be de minimis).Back To Text

[47] Black's Law Dictionary 431 (6th ed. 1990).Back To Text

[48] Although the de minimis exception is interpreted expansively by many bankruptcy courts, the courts of appeal tend to adopt a "plain language" interpretation of the disinterestedness standard. For example, the bankruptcy court in the *Federated Dep't Stores* case applied the de minimis exception to a professional holding a $104,000 claim and 20,343

shares of the debtor's stock in an opinion that focused on the need "to balance the risk and gravity of the potential conflict of interest with the costs that the estate and perhaps the public would incur in the event of disqualification of the professional." In re Federated Dep't Stores, Inc., 114 B.R. 501, 504 (Bankr. S.D. Ohio 1990). The Sixth Circuit reversed, holding that section 327(a) prevents the courts from basing the disinterestedness determination on equitable concerns or the best interest of the debtor. *See* Michel v. Federated Dep't Stores, Inc. (In re Federated Dep't Stores, Inc.), 44 F.3d 1310, 1318 (6th Cir. 1995). In a more extreme distortion of theory, the bankruptcy court in *In re Sharon Steel Corp.* relied on the economic realities of the case to hold that a $875,894 claim was not disqualifying, even though the claim made the professional one of the estate's largest creditors. In re Sharon Steel Corp., 152 B.R. 447, 448−49 (Bankr. W.D. Pa. 1993). The Third Circuit reversed, even though it would cost the estate half a million dollars to replace the professional. *See* Price Waterhouse, 19 F.3d at 140−42. Despite these high profile reversals, bankruptcy courts likely will continue to apply the de minimis exception, although perhaps without publishing their opinions.Back To Text

[49] This issue can appear in cases involving both large and small corporate debtors. An extreme example is the Delaware attorney who is corporate secretary for 7,000 companies incorporated in that state. *See* Panel Discussion, *Ethics: Is Disinterestedness Still a Viable Concept?* A Discussion, 5 Am. Bankr. Inst. L. Rev. 201, 230−31 (1997) (comments of Hon. Charles N. Clevert).Back To Text

[50] The leading case on imputation of disinterestedness is Creative Restaurant Management, 139 B.R. at 913−15 (holding that whole law firm is not ineligible for employment because individual member previously had been officer of debtor). *See also* United States Trustee v. S.S. Retail Stores Corp. (In re S.S. Retail Stores Corp.), 211 B.R. 699, 704 (B.A.P. 9th Cir. 1997) (concluding that per se rule does not disqualify entire firm based on individual attorney); Capen Wholesale, Inc. v. Michel (In re Capen Wholesale, Inc.), 184 B.R. 547, 551 (N.D. Ill. 1995) (stating that even though individual attorney may be disqualified as "non−disinterested person," nothing suggests that other lawyers at firm be viewed similarly). *But see* Value Property Trust v. Zim Co. (In re Mortgage & Realty Trust), 195 B.R. 740, 754−56 (Bankr. C.D. Cal. 1996) (imputing "of counsel" attorney's status as former director to entire firm).Back To Text

[51] *See, e.g.,* Creative Restaurant Management, 139 B.R. at 915 (discussing importance of analyzing whether appropriate safeguards exist to protect interests of all parties); *cf.* Mortgage & Realty Trust, 195 B.R. at 756 (law firm failed to erect an ethical wall); *see also* Kelbon et al., supra note 41, at 451−55 (discussing use of ethical wall in various circumstances).Back To Text

[52] These cases lose sight of the prophylactic nature of section 101(14)(D) and effectively read it out of the statute. Since the only attorneys subject to the per se rule would be sole practitioners, and since it will be fairly rare that a sole practitioner is employed to represent a trustee or debtor−in−possession in a corporate case, the section would almost never be applicable. *See* Lynn M. LoPucki, The Demographics of Bankruptcy Practice, 63 Am. Bankr. L.J. 289, 314 (1989).

Further, section 101(14)(D) is based on the premise that hiring an attorney who is a corporate secretary poses such an unacceptable risk to the integrity of the system that per se disqualification is required. It is simply inconsistent with that premise to adopt a rule permitting the employment of a two−person firm, where one of the partners is the corporate secretary. Moving to a 100−member firm is merely a change in the extent of the relationship, not in its type.

Finally, the "person distinction" presumably would apply equally well to most of the remaining per se categories of disinterestedness. Since a professional firm, as opposed to its members, will almost never be an equity security holder, a director, an officer, or an employee of the debtor, or director, an officer, or an employee of an investment banker, such an interpretation would collapse most of the disinterestedness rule into the subsection (E), the materially adverse interest standard. Already at least one case has extended the *Creative Restaurant Management* rule to refuse to impute a partner's director status and equity interest to the firm. *See* Vergos v. Timber Creek, Inc., 200 B.R. 624, 627 (W.D. Tenn. 1996); *contra* In re Intech Capital Corp., 87 B.R. 232, 235 (Bankr. D. Conn. 1988) (attorneys direct disqualification because of shareholder status results in indirect disqualification of associated attorneys).Back To Text

[53] *See, e.g.,* Creative Restaurant Management, 139 B.R. at 914−15 (weighing factors of economic and efficient administration, value of firm's experience and familiarity with debtor, and long−standing relationship with client); In re Martin, 817 F.2d 175, 182 (1st Cir. 1987) (weighing factors of delay and fundamental fairness in objective test).Back To Text

[54] *See* Martin, 817 F.2d at 182 (explaining difference between actual and potential conflicts); *see also* In re Diamond Mortgage Corp., 135 B.R. 78, 91 (Bankr. N.D. Ill. 1990) (stating there is distinction between actual and potential conflicts). *See, e.g.,* Joseph D. Vaccaro & Marc Milano, Note, *Bankruptcy Code Section 327(a), A Statute in* Conflict: A Proposed Solution, 5 Am. Bankr. Inst. L. Rev. 237, 241 (1997) (noting it is universal that actual conflicts are disqualifying): Chrisptoher M. Ashby, Comment, *Bankruptcy Code Section 327(a) and Potential Conflicts of Interest – Always or Never Disqualifying*?, 29 Hous. L. Rev. 433, 441 nn.38−41 (1992) (distinguishing between cases which disqualify for any conflict and those which disqualify only for actual conflict). *Back To Text*

[55] *See, e.g.,* Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir. 1994) (expense and delay); Harold & Williams Dev. Co. v. United States Trustee (In re Harold & Williams Dev. Co.), 977 F.2d 906, 910 (4th Cir. 1992) (efficient, expeditious and economical resolution); Martin, 817 F.2d at 182 (stating court should consider full panoply of events and elements); In re Caldor, Inc., 193 B.R. 165, 177 (Bankr. S.D.N.Y. 1996) (noting "problems are far outweighed by the certain costs and delay to creditors and disruption to this case if the Professionals are disqualified"); Robin E. Phelan & John D. Penn, Bankruptcy Ethics, An Oxymoron, 5 Am. Bankr. Inst. L. Rev. 1, 21 (1997) (cases use distinction to balance section 327(a) requirements against economy and practicality concerns). The principal appellate case cited to support the flexible weighing test for potential conflicts is In re BH & P, Inc., 949 F.2d 1300, 1315−16 (3d Cir. 1991). Although the *BH & P* opinion appears to adopt a "flexible" approach and even mentions the expense and disruption considerations, the Third Circuit recently rejected that interpretation of BH & P. See United States Trustee v. Price Waterhouse, 19 F.3d 138, 142 (3d Cir. 1994). Back To Text

[56] In re Codesco, Inc., 18 B.R. 997, 999 (Bankr. S.D.N.Y. 1982). *See* In re Kendavis Indus. Int'l Inc., 91 B.R. 742, 754 (Bankr. N.D. Tex. 1988) (stating "[t]he concept of *potential* conflicts is a contradiction in terms. Once there is a conflict, it is *actual −− not potential*") (emphasis in original).Back To Text

[57] The Commission Report states, "[n]o one presented evidence showing a shortage of capable debtors' counsel, harm to debtors or the system resulting from disqualification of interested counsel, or that any such unproven harm would outweigh the policies favoring impartial counsel." Commission Report, supra note 1, at 880−81.Back To Text

[58] The cases adopting a flexible interpretation of the rules demonstrate that in those cases at least the judges have found it necessary to employ interested professionals. *See, e.g.,* Diamond Mortgage Corp., 135 B.R. at 91 (providing that some courts are more flexible when interpreting conflict of interest by analyzing on case−by−case basis); In re Stamford Color Photo, Inc., 98 B.R. 135, 138 (Bankr. D. Conn. 1989) (stating potential for conflicts is not sufficient basis for disqualifying); In re Oliver's Stores, Inc., 79 B.R. 588, 595−96 (Bankr. D. N.J. 1987) (explaining potential conflicts are not grounds for per se disqualification), aff'd, 1990 WL 102353 (D. N.J. 1990). Back To Text

[59] As both professional firms and bankruptcy cases grow larger, the possibility that every law firm capable of handling the case will have at least one minor conflict of interest becomes greater. Apart from the exceptions created by case law, the current rules provide no mechanism for dealing with this very real possibility.Back To Text

[60] *See* Commission Report, supra note 1, at 882 (stating that "[t]he recommendation will eliminate the over−inclusive reach of the disinterestedness requirement in the narrow situations described").Back To Text

[61] *See* id. at 882 (explaining that professional's interest is not far from that of other unsecured creditors and professional is unlikely to be influenced).Back To Text

[62] *See* id. at 870−83 (discussing Commission's clarification of disinterestedness standard) (comments by Commissioner Jones).Back To Text

[63] *See* Michel v. Federated Dep't Stores, Inc. (In re Federated Dep't Stores, Inc.), 44 F.3d 1310, 1318 (6th Cir. 1995). In a chapter 11 case, section 327(a) is made applicable by section 1107(a), however, section 1107(b) provides an exception to section 327(a). Where a person served as prepetition counsel for debtor−in−possession, and where that person is not disqualified to represent the debtor−in−possession under any other bankruptcy code provision, such person is not disqualified to represent the debtor−in−possession. *See* id. Back To Text

[64] *See* 11 U.S.C. § 1107(b) (1994); Federated Dep't Stores, 44 F.3d at 1318 (providing that person is not disqualified for employment because of prepetition representation of debtor under section 1107(b)).Back To Text

[65] *See* Federated Dep't Stores, 44 F.3d at 1319 (stating "[t]o read § 1107(b) as providing an exception in this case would be to rob section 101(14)(B) and (C) of any meaning in cases with debtors−in−possession") (citing Michel v. Eagle−Picher Indus. (*In re* Eagle−Picher Indus.), 999 F.2d 969. 972 (6th Cir. 1993)); United States Trustee v. Price Waterhouse, 19 F.3d 138, 142 (3d Cir. 1994) (finding no ambiguity in language of section 327(a)).Back To Text

[66] *See* Williams, supra note 45, at 317 (providing that because of section 327's disinterestedness requirement, attorney must waive prepetition fees or refer case to another attorney); *see also* Westbrook, supra note 4, at 300−01 (obtaining full payment of fees also eliminates creditor status but may expose professional to possible section 547 preference action, which could be disqualifying); In re Brennan, 187 B.R. 135, 152 (Bankr. D. N.J. 1995) (noting that such waivers enable debtors to employ same professionals). The professional could avoid creditor status by demanding payment in advance or by obtaining a retainer. Ironically, those steps require the professional to place her fee interest ahead of the needs of the cash−strapped client and might also be disqualifying. *See* In re Martin, 817 F.2d 175, 181−82 (1st Cir. 1987) (mortgage to secure fees).Back To Text

[67] *See* supra note 45 and accompanying text.Back To Text

[68] In re Martin, 817 F.2d 175, 180 n.5 (1st Cir. 1987) (providing that routine preliminary prepetition work for chapter 11 filing will not disqualify otherwise eligible attorney); *see, e.g.,* In re Creative Restaurant Management Inc., 139 B.R. 902, 916−17 (Bankr. W.D. Mo. 1992) (same).Back To Text

[69] The Commission viewed such distinctions as "artificial and unrealistic." *See* Commission Report, *supra* note 1, at 882.Back To Text

[70] Ironically, the Commission's solution might be worse for the professionals than the original problem. Because of the per se disqualification rules, the courts generally have been sympathetic to the professional's use of various prepetition strategies to pay the fees and avoid creditor status. *See* In re Brennan, 187 B.R. 135, 153 (Bankr. D.N.J. 1995) (distorting section 547(b)(2) definition of "owed" to protect professional from disqualification for receiving prepetition payment of fees); Creative Restaurant Management, 139 B.R. at 916−17 (using section 329 to protect prepetition fee payment from preference attack). *But see* Martin, 817 F.2d at 180 (stating "the argument that § 329 shaves the authority that § 327 plainly requires is best dismissed as wishful thinking"); In re Crisp, 64 B.R. 351, 352 (Bankr. W.D. Mo. 1986) (providing that prepetition payment of legal fees is avoidable as preferential). If the professionals can retain their fee claims in bankruptcy, the courts may find that the use of advance knowledge of the bankruptcy filing to obtain an advantage over other unsecured creditors is itself a disqualifying conflict. *See* Crisp, 64 B.R. at 352. Back To Text

[71] *See* Commission Report, supra note 1, at 870−883 (Comments by Commissioner Jones); *see also* Ann M. Hart, Note, *The Model Rules Are Close and the Restatement is Closer—But, Neither is Quite Right Lawyers Who Trade in* Their Client's Securities: Why This Should Be Unethical, 10 Geo. J. Legal Ethics 185, 191 (1996) (discussing ethical issues raised by lawyer's trading in their client's stock).Back To Text

[72] Apparently no published opinion discusses the effect of a trivial equity interest held by a member of a large professional firm in a large publicly traded debtor. The reported cases deal with either large stock holdings or small debtors. *See* In re Intech Capital Corp., 87 B.R. 232, 234−35 (Bankr. D. Conn. 1988) (disqualifying law firm because member of firm representing debtor owned four percent of debtor's stock); In re O'Connor, 52 B.R. 892, 898 (Bankr. W.D. Okla. 1985) (discussing scenario where attorney owns stock of corporate debtor while representing bankrupt

principal of same corporation); In re Anver Corp., 44 B.R. 615, 621−22 (Bankr. D. Mass. 1984) (disqualifying law firm because debtor owned one percent of debtor's equity).Back To Text

[73] Prepetition strategies for eliminating the interest are more limited for equity security interests than for claims. Since the professional has non−public information regarding the planned chapter 11 filing, the securities laws make it difficult for the professional to sell the interests prepetition. *See generally* United States v. O'Hagan, 117 S.Ct. 2199, 2207 (1997) (discussing misappropriation of material nonpublic information by lawyer); Carpenter v. United States, 484 U.S. 19, 23−24 (1987) (discussing misappropriated information held by company not preparing to engage in securities transactions); Chiarella v. United States, 445 U.S. 222, 235−37 (1980) (discussing appropriateness of misappropriation theory).Back To Text

[74] Currently, because of economic circumstance and interest rates, there is a massive switch to mutual funds as an investment vehicle. *See* Charles Marinaccio, Bank Fund Customers Have Ample Protection Under Present Laws, 13 Banking Pol'y Rep. 1, 17−18 (1994).Back To Text

[75] Mutual funds typically do not make contemporaneous disclosure of their securities transactions. The investor only discovers which securities were held by the fund after the fact. *See generally* Robert A. Robertson & Bradley W. Paulson, A Methodology for Mutual Fund Derivative Investments, 1 Stan. J.L. Bus & Fin. 237, 249 (1995) (stating that advertisements for many funds convey unclear messages to potential investors). Back To Text

[76] *See* Commission Report, supra note 1, at 869−83.Back To Text

[77] Mutual fund investing raises a number of interesting questions from a conflict perspective. For example, should the fact that the investment is indirect insulate the professional from equity security holder status even though the value of the investment is tied to the underlying security? In addition to the disclosure problem noted in the text, what effect should the investor's lack of knowledge or control over the investment have? While one could argue that the lack of knowledge supports a rule completely excluding mutual funds from consideration, the investor may be able to make a fairly accurate guess as to which securities are held by the fund. Should even greater scrutiny be applied when the professional is investing in "vulture funds" that invest only in chapter 11 debtors?Back To Text

[78] *See* Commission Report, *supra* note 1, at 870−71, 881−83 (noting purpose of change is to assist chapter 11 debtors only).Back To Text

[79] *See* Michel v. Federated Dep't Stores, Inc. (In re Federated Dep't Stores, Inc.), 44 F.3d 1310, 1318 (6th Cir. 1995) (discussing professionals prepetition fee claims in bankruptcy).Back To Text

[80] *See* In re Federated Dep't Stores, Inc., 114 B.R. 501, 504−05 (Bankr. S.D. Ohio 1990) (discussing difficulty in disqualifying professional where debtor is large or complex), rev'd in part, 44 F.3d 1310 (6th Cir. 1995).Back To Text

[81] *See* Commission Report, supra note 1, at 869, 873 (stating that "[t]he Recommendation would amend § 1107(b) to exempt from the strict disinterestedness requirement those situations in which a professional who seeks to represent the debtor or trustee held an insubstantial unsecured prepetition claim against or equity interest in the debtor").Back To Text

[82] *See* id. at 881−83.Back To Text

[83] *See* In re O'Connor, 52 B.R. 892, 899 (Bankr. W.D. Okla. 1985) (finding .0077% equity interest in debtor owned by professional representative was insignificant).Back To Text

[84] Commission Report, *supra* note 1, at 882.Back To Text

[85] *See id.* at 881.Back To Text

[86] *See generally* In re Interco Inc., 127 B.R. 633, 638 (E.D. Mo. 1991) (finding that services performed by examiner's counsel were minor and did not constitute conflict of interest).Back To Text

[87] *See* In re Sauer, 191 B.R. 402, 408 (D. Neb. 1995) (stating "professionals engaged in the conduct of a bankruptcy estate should be free of the *slightest* personal interest which might be reflected in their decisions concerning matters of the debtor estate or which *might* impair the high degree of impartiality . . . expected of them") (citing In re Philadelphia Athletic Club, Inc., 20 B.R. 328, 334 (E.D. Pa. 1982) (emphasis in original)).Back To Text

[88] *See* id. (seeking to eliminate over inclusive reach of disinterestedness requirement).Back To Text

[89] The proposed merges of Ernst & Young with KPMG Peat Marwick and Price Waterhouse with Coopers and Lybrand would result in only four major accounting firms. *See generally* Reed Abelson, *In Big Corporate Accounting, Will 4 Be Sufficient?,* N.Y. Times, Oct. 21, 1997, at D1. Back To Text

[90] *See* Abelson, supra note 89, at D1; *see also* Eileen Glanton, *Top Accounting Firms Merge; Plans are to Capitalize on Increased Demand for Consulting Services,* Sun Sentinel, Oct. 21, 1997, at 3D (discussing mergers of top accounting firms and growth of consulting services).Back To Text

[91] This inference is supported by the statutory construction rule *expressio unius est exclusio alterius*. *See* 2A Sutherland Stat. Const. § 47.23 p. 216 (5th ed. 1992). Further, that conclusion is adopted by the Commission's report. The report states:

> [O]ne thing is clear: in order to serve as counsel to a debtor−in−possession or trustee, an attorney is required to show a lack of *any* interest adverse to the estate, *regardless* of materiality.
>
> The Recommendation would amend § 1107(b) to exempt from the strict disinterestedness requirement those situations in which a professional who seeks to represent the debtor or trustee held an insubstantial unsecured prepetition claim against or equity interest in the debtor.

Commission Report, supra note 1, at 872−73 (emphasis in original). The reference to "trustee" in the final sentence appears to be an error since the recommendation only affects professionals employed by a debtor−in−possession.Back To Text

[92] This central purpose is reflected in the three reasons cited for the disinterestedness requirement. *See* Commission Report, supra note 1, at 873−77. The first and third reasons deal with the need to ensure independent professional judgment, while the second reason deals with the need to assure the public that bankruptcy professionals actually are exercising independent professional judgment. *See* id. Back To Text

[93] *See generally,* Wolfram, supra note 35, § 7.1 *et seq.* at 312 and accompanying text. Would anyone seriously contend that an attorney could ethically represent the executor of a probate estate in a case where the attorney was bequeathed $1,000,000 under the will, which was an "insubstantial" amount in relation to the total estate? See April A. Fegyveresi, Note, *Conflicts of Interests in* Trust & Estate Practice, 8 Geo. J. Legal Ethics 987, 1007 (1995), where the author discusses how "substantial" testamentary gift to drafting lawyer should be determined by reference to both the size of probate estate and lawyer's own assets. Back To Text

[94] Commission Report, supra note 1, at 882. Even this definition provides little guidance to the courts. While the definition establishes that the estate is the point of reference, no method is suggested for determining when an interest is substantial. In practice, the answer to that question will probably turn as much on a cost/benefit analysis as it does on the relative size of the interest.Back To Text

[95] *See* Fegyveresi, supra note 93, at 1007 (discussing how to determine when trust and estate lawyers face professional and ethical dilemmas).Back To Text

[96] Even those courts adopting a flexible approach to disinterestedness ask whether the interest creates a meaningful incentive for the professional to act contrary to the best interest of the estate. See In re Martin, 817 F.2d 175, 180 (1st Cir. 1987), where the court recognizes that the bankruptcy court has a duty to root out impermissible conflicts of interest between an attorney and the client. See also In re Leslie Fay Cos. Inc., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994), where the court defines the issue as whether an incentive exists that would cause debtor's attorneys to act any differently than they would without the conflict. Back To Text

[97] This would require some inquiry into the financial condition of both the professional and his or her firm. It might also require an inquiry into the firm's compensation practices and, in particular, the effect that nonpayment of the claim might have on the individuals handling the estate's affairs. Back To Text

[98] For example, the Macy's bankruptcy involved more than 5.5 million dollars in liabilities. The 1994 Bankruptcy Yearbook & Almanac 68 (Christopher M. McHugh ed. 4th ed. 1994).Back To Text

[99] *See* Commission Report, supra note 1, at 881.Back To Text

[100] *See* 11 U.S.C. § 327(a) (1994). Back To Text

[101] A few cases read this language expansively with respect to the existing section 1107(b) exception for prepetition employment. *Compare* In re Microwave Prods. of Am., Inc., 94 B.R. 971, 973−74 (Bankr. W.D. Tenn. 1989) (overriding disinterestedness regarding fee claim by section 1107(b)), *with* First Interstate Bank of Nev., N.A. v. CIC Inv. Corp. (In re CIC Inv. Corp.), 175 B.R. 52, 55−56 (B.A.P. 9th Cir. 1994) (regarding interpretation of section 1107(b) to exclude section 327(a) requirements as so "tortured" to be unacceptable). *See also* Interwest Bus. Equip. Inc. v. United States Trustee (In re Interwest Bus. Equip. Inc.), 23 F.3d 311, 316 (10th Cir. 1994) (rejecting similar argument under section 327(c) "representation of a creditor" exception). Under the current section, courts can draw a distinction between the fact of the prior employment, which cannot be the "sole" reason for disqualification, and the interests that arise because of the prior employment, which can be disqualifying. *See* id. However, the argument that section 327(a) is pre−empted is stronger under the proposal because it is not possible to draw a real distinction between the fact of an insubstantial claim and the creditor interest that arises because of that insubstantial claim. Back To Text

[102] Lawyers must satisfy both the Code's requirements and the applicable professional ethics standards. *See* supra note 39 and accompanying text. Thus, for lawyers the conflict rules under applicable ethical codes, coupled with the court's power to supervise the attorneys appearing before it, may provide an alternative basis for disqualification. *See* In re Vanderbilt Assocs., 117 B.R. 678, 681 (D. Utah 1990) (noting adoption of Utah Rules of Professional Conduct, and Code of Professional Responsibility). *But see* In re Global Marine, Inc., 108 B.R. 998, 1005 (Bankr. S.D. Tex. 1987) (stating that sections 327 and 1103(b) carved out exceptions to state ethics code's "appearance of impropriety" standard).Back To Text

[103] *See* Commission Report, supra note 1, at 871 (discussing Commission's notion that some professionals are disqualified unnecessarily due to insubstantial claims and conflicts).Back To Text

[104] *See generally* Wolfram, supra note 35, § 7.2 at 337 (noting client can consent to and acknowledge attorney's conflict of interest). Back To Text

[105] The assumption and rejection of leases and executory contracts under 11 U.S.C. § 365 are traditionally evaluated under the business judgment test. *See* National Labor Relations Bd. v. Bildisco & Bildisco, 465 U.S. 513, 523 (1984).Back To Text

[106] *Cf.* 11 U.S.C. § 1113(c)(3) (1994) (stating standard for rejecting collective bargaining agreements).Back To Text

[107] *Cf.* 11 U.S.C. § 364(d)(1)(A) (stating standard for approving priming lien for postpetition credit).Back To Text