One Person Can Knock Out Our Firm?
Imputation and Retention Risks for Professionals Under Chapter 11

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Introduction

The Bankruptcy Code applies demanding ethical standards for the retention of a debtor's professionals to ensure that such professionals' interests are directly aligned with those of the debtor's bankruptcy estate. Issues potentially arise when one or more individuals associated with a large firm that would otherwise meet these rigorous standards do not themselves. Do one or more individuals irrevocably taint and disqualify the entire firm? Can walls and proper disclosures to the Bankruptcy Court solve the issue? Do courts apply these standards equally to law firms and other estate professionals, such as financial advisors and investment banks? This article examines the current legal landscape relating to these issues.

Under section 327 of the Bankruptcy Code, a debtor may employ only "professional persons" who are "disinterested persons," that is, those who are not or were not, within two years of the date of the bankruptcy filing, directors, officers or employees of the debtor, and who do not hold or represent an interest adverse to the debtor's estate. Where a debtor seeks to retain a professional advisor, the "person" being retained is generally the professional firm itself, not any particular individual professional.

Nevertheless, the fact pattern gets complicated where an affiliated individual is himself or herself not "disinterested," often by virtue of being or having recently been an officer or director of the debtor. This is because of the view, or risk, that the non-disinterestedness of a member of a professional firm is imputed to the firm as a whole. In the law firm context, court rulings have diverged on whether the failure of a particular professional to be disinterested should be imputed to the entire firm. While a few courts have applied a "per se" rule disqualifying law firms due to the non-disinterestedness of a single professional, the majority of courts have declined to adopt such a per se rule, including in the financial advisor context.

Courts, other than the few applying a per se rule of imputation, have generally approved the retention of professional firms employing non-disinterested individuals when those firms both made fulsome disclosures of such relationships and potential conflicts, and also implemented rigorous ethical walls and information barriers between the implicated professional and the members of the firm working for the debtor. Such walls should bar the conflicted person from access to files or documents related to the debtor's case and prohibit discussions of the debtor's case with or in the presence of that person.

In more extreme circumstances or when faced with an unusually skeptical court, a non-disinterested professional could resign from the position that triggered non-disinterestedness to prevent the Bankruptcy Court from disqualifying their firm. Further, a court may even require a firm disgorge any fees earned during the period when the firm was rendered non-disinterested. Finally, financial advisory firms may utilize the "Alix

Protocol" and seek retention under section 363(b) in order to provide a debtor with a chief restructuring officer prior to a bankruptcy filing and also enable the firm to be retained by the debtor in the bankruptcy.

<u>Bankruptcy Code Requirements for Debtor's Retention of Professionals</u>

The Bankruptcy Code authorizes a debtor, subject to Bankruptcy Court approval, to employ estate professionals, including attorneys, accountants and other professional persons.[1] Under section 327, a debtor may only employ professionals who are "disinterested" and do not hold or represent an interest adverse to the debtor's estate.[2]

Courts have found that to hold an adverse interest is

> (i) 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 (ii) to possess a predisposition under circumstances that render such bias against the estate.[3]

The Bankruptcy Code defines "Disinterested Person" as a person who (i) is not a creditor, equity holder or insider, (ii) is not and was not, within two years before the filing date, a director, officer or employee of the debtor and (iii) does not have an interest materially adverse to the interest of the estate or any class of creditors or equityholders due to any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.[4] Importantly, the failure to be disinterested cannot be waived by the consent of creditors and the debtor. If a professional person is not disinterested, they are prohibited from being retained by the debtor.[5]

The Bankruptcy Code further defines "person" to include "an individual, a partnership or a corporation,"[6] and "attorney" as an "attorney, professional law association, corporation, or partnership, authorized under applicable law to practice law."[7] Thus, a debtor may retain either a single lawyer or a law firm as an "attorney," either of which would be subject to the requirements of section 327.

Professionals retained by the debtor are subject to strict disclosure requirements under the Federal Rules of Bankruptcy Procedure, which require a detailed application disclosing, among other things, "the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, . . . [such professional's] connections with the debtor, creditors, any other party in interest, their respective attorneys and

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[1] 11 U.S.C. § 327.
[2] *Id.* § 327(a).
[3] *In re AroChem Corp.*, 176 F.3d 610, 623 (2d Cir. 1999); *In re Black & White Stripes, LLC*, 623 B.R. 34, 49 (Bankr. S.D.N.Y. 2020); *In re Envirodyne Indus., Inc.*, 150 B.R. 1008, 1016 (Bankr. N.D. Ill. 1993).
[4] 11 U.S.C. § 104(14).
[5] *See In re Nilhan Developers, LLC*, No. 15-58443-WLH, 2021 WL 1539354, at *11 (Bankr. N.D. Ga. Apr. 19, 2021); *In re Granite Partners, L.P.*, 219 B.R. 22, 34 (Bankr. S.D.N.Y. 1998).
[6] 11 U.S.C. § 104(41).
[7] *Id.* § 104(4).

accountants, the United States trustee, or any person employed in the office of the United States trustee."[8] "[A]n applicant must disclose all connections regardless of whether they rise to the level of a disqualifying interest under section 327."[9] Failure to do so is an independent basis to sanction or disqualify a professional.[10]

Legal Landscape of Imputation of Non-Disinterestedness

Courts have split on the issue of imputation of non-disinterestedness for lawyers and law firms. Courts applying a per se rule of imputation have yet to address the issue in the financial advisor or investment bank context,[11] but at least one court has rejected a per se rule in approving the retention of a financial advisor despite the non-disinterestedness of one of its employees.

Per se Rule of Imputation of Non-Disinterestedness

The seminal case for the per se rule of imputation arose in the Bankruptcy Court for the District of Delaware. In *In re Essential Therapeutics, Inc.*,[12] Judge Walrath not only disqualified a law firm partner from serving as counsel to the debtors due to his prior service as an officer to several of the debtors, but also imputed his non-disinterestedness to his entire firm, disqualifying the entire firm.[13]

In *Essential Therapeutics*, counsel's retention application disclosed that a partner at the firm had been the corporate secretary for several of the debtors at various points within two years of the debtors' bankruptcy filing.[14] The U.S. Trustee objected to the retention application, arguing that the partner's service as corporate secretary disqualified the entire firm under section 327.[15]

Though the firm offered to establish an ethical wall between the non-disinterested partner and those involved in the debtors' cases, the court agreed with the U.S. Trustee that an ethical wall could not "cure" the disqualification and adopted a per se rule of imputation.[16]

The court premised its holding on the nature of law firms and the ethical rules governing legal practice. Specifically, the court looked to precedent relying on the policy of the

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[8] Fed. R. Bankr. P. 2014(a).
[9] *In re Nilhan Developers, LLC*, 2021 WL 1539354, at *14.
[10] *See In re Universal Bldg. Prods.*, 486 B.R. 650, 663 (Bankr. D. Del. 2010) ("Failure to disclose connections itself is enough to warrant disqualification of counsel from employment."); *In re Granite Partners, L.P.*, 219 B.R. 22, 41 (Bankr. S.D.N.Y. 1998) ("At a minimum, failure to disclose is an exacerbating factor warranting the reduction or denial of fees for lack of disinterestedness. . . .").
[11] Financial advisors are distinguishable from investment bankers in that the former provide business, financial and operational advice and services to a debtor, whereas investment bankers engage in efforts to raise capital, market businesses or formulate strategic transactions for debtors and their boards of directors.
[12] 295 B.R. 203 (Bankr. D. Del. 2003).
[13] *Id.* at 211.
[14] *Id.* at 205–06.
[15] *Id.*
[16] *Id.* at 208–11.

Model Rules of Professional Conduct[17] and the Bankruptcy Code dictating the imputation of disqualification in certain conflict-of-interest scenarios.[18] The court reasoned that "a law firm is an association of individuals; the firm can only act through those individuals; and, therefore, the disqualification of one must be attributed to all."[19] Further, the court found that not applying a per se rule of disqualification would be administratively impossible, requiring the court to "interrogate" all firm attorneys working on the debtors' case to determine whether the disqualified individual would impair the other attorneys' impartiality, which would be a "herculean task."[20] Finally, citing a "climate of distrust of officers and directors," the court remarked that debtors' officers could be subject to suit, in which case a firm could be perceived as not being impartial due to a partner's service to the debtor during the two-year lookback period.[21]

Though decided approximately 20 years ago, *Essential Therapeutics* continues to be cited favorably in the District of Delaware, suggesting that the per se imputation rule remains applicable (or at least a possible outcome) in that district.[22]

Rejection of Per se Rule

The majority of courts to address the imputation issue more recently have declined to follow *Essential Therapeutics* and have rejected a per se rule of imputation, including in cases involving financial advisory firms.

These courts, including the Bankruptcy Appellate Panel for the Ninth Circuit, the Bankruptcy Court for the Southern District of Texas and the Bankruptcy Court for the Northern District of Illinois, have cited several reasons for rejecting a per se rule of imputation.

First, the plain language of section 327 does not provide for the imputation of non-disinterestedness to an individual professional's entire firm.[23] Courts have interpreted the definition of "person" in section 101(41) — "an individual, a partnership or a corporation" — to distinguish a law firm as a distinct "person" from a non-disinterested individual

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[17] The Model Rules of Professional Conduct prescribe lawyers' professional responsibilities and are often codified in state law. The Model Rules of Professional Conduct, which address conflicts of interest, provide for the imputation of a conflict to the conflicted lawyer's firm in certain circumstances. *See* Model Rules of Prof'l Conduct 1.10 (2009).
[18] *In re Essential Therapeutics*, 295 B.R. at 209–10.
[19] *Id.* at 210.
[20] *Id.*
[21] *Id.* at 210–11.
[22] *See In re NNN 400 Capital Ctr. 16 LLC*, 632 B.R. 243, 273 (D. Del. Sept. 29, 2021).
[23] *See, e.g.*, *In re S.S. Retail Stores Corp.*, 211 B.R. 699, 703–04 (B.A.P. 9th Cir. 1997); *In re Capen Wholesale, Inc.*, 184 B.R. 547, 551 (N.D. Ill. 1995); *In re McDermott Int'l, Inc.*, 614 B.R. 244, 254 (Bankr. S.D. Tex. 2020); *In re Nilhan*, 2021 WL 1539354, at *13; *In re YMCA*, 570 B.R. 64, 68 (Bankr. W.D. Mich. 2017); *In re Sea Island Co.*, No. 10-21034, 2010 WL 4386855, at *2 (Bankr. S.D. Ga. Oct. 20, 2010); *In re Cygnus Oil & Gas Corp.*, No. 07-32417, 2007 WL 1580111, at *3 (Bankr. S.D. Tex. May 29, 2007); *In re Timber Creek, Inc.*, 187 B.R. 240, 244 (Bankr. W.D. Tenn. 1995); *In re Creative Rest. Mgmt. Inc.*, 139 B.R. 902, 912–13 (Bankr. W.D. Mo. 1992).

professional.[24] Several courts have also pointed to the language of section 101(14)(C), which provides that a "disinterested person" "does not have an interest materially adverse to the interest of the estate . . . by reason of any *direct or indirect relationship* to . . . the debtor" as further support that Congress did not intend for there to be a per se rule of imputation for current or prior service to the debtor, since section 101(14)(B), which addresses such current or prior service, does not contain such "direct or indirect" language.[25]

Second, some courts have criticized reliance on the Model Rules of Professional Conduct because such rules "only come into play with actual conflicts."[26] According to such courts, in the absence of any actual conflict, the Model Rules should have no relevance in determining whether a person was a director, officer or employee of the debtor within the two years prior to the debtor's petition date.

In a recent case involving a financial advisory firm, the Bankruptcy Court for the Southern District of Texas expressly rejected the holding of *Essential Therapeutics*, and held instead that the non-disinterestedness of a partner who was serving as the debtor's chief transformation officer, but was also employed by the debtors' proposed financial advisor, should not be imputed to his firm.[27] The court based its holding on the plain text of the Bankruptcy Code, which, the court found, does not provide for imputation of non-disinterestedness due to current or prior service to the debtor.[28] The court noted that Congress has provided for imputation in other parts of the bankruptcy system, for example, the disqualification of a professional related to a bankruptcy judge, which is imputed to that professional's firm.[29] The Texas Bankruptcy Court questioned the *Essential Therapeutics* court's invocation of a "climate of distrust of officers and directors," finding it an insufficient reason to read an "otherwise nonexistent condition" into the Bankruptcy Code.[30] However, the Bankruptcy Court noted that a "case-by-case approach to imputation of a lack of disinterestedness" addresses the concerns raised by advocates of the per se rule, thus leaving the door open for imputation in the "inevitable unusual case."[31]

Though we are not aware of any cases involving a challenge to the retention of an investment bank due to prepetition service of its individual employees to the debtor, the Bankruptcy Court for the Southern District of New York in *In re SAS* recently addressed

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[24] *See, e.g.*, *In re Nilhan*, 2021 WL 1539354, at *13; *In re Sea Island Co.*, 2010 WL 4386855, at *2; *In re Cygnus Oil & Gas Corp.*, 2007 WL 1580111, at *3.
[25] *In re YMCA*, 570 B.R. at 68; *see also In re Nilhan*, 2021 WL 1539354, at *13 (finding that an imputation inquiry is appropriate under subsection (C), but not (A), of the definition of "Disinterested Person"); *In re Sea Island Co.*, 2010 WL 4386855, at *2 (same); *In re Cygnus Oil & Gas Corp.*, 2007 WL 1580111, at *3 (same).
[26] *In re YMCA*, 570 B.R. at 68; *see also In re S.S. Retail Stores Corp.*, 211 B.R. 699, 703–04 (B.A.P. 9th Cir. 1997); *In re Creative Rest. Mgmt. Inc.*, 139 B.R. at 912.
[27] *In re McDermott*, 614 B.R. at 247, 254.
[28] *Id.* at 254.
[29] *Id.*
[30] *Id.*
[31] *Id.* at 255.

related issues in connection with the disinterestedness of an investment bank.[32] There, the U.S. Trustee challenged an investment bank's retention on the grounds that it held materially adverse interests to the estate.[33] In particular, the family of the chairman of the board of the investment bank was associated with several nonprofit public and private foundations (the "Foundations"), which owned an investment entity that held, among other investments, 3.42% of the common stock of SAS.[34] The U.S. Trustee took issue with the chairman's association with the Foundations, arguing that the relationship could create conflicts of interest for the investment bank if, for example, due to the chairman's relationship, the investment bankers favored the debtors' equity interests (indirectly held by the Foundations), or if the chairman instructed the investment bankers to do so.[35]

The court found that the chairman's association with the Foundations (and, indirectly, with the debtors) was not a disqualifying material adverse interest under the disinterested test because neither the chairman himself nor the investment bank owned any stock in SAS and there was "no suggestion" that the chairman had "any personal interest in the investments of the assets of the Foundations" due to his association therewith.[36] Nevertheless, the court required the establishment of an ethical wall between the chairman and the relevant investment bankers.[37] The chairman further agreed not to participate in any discussions or votes relating to the debtors at directors' meetings for the Foundations.[38] Although the chairman did not actually serve as a director, officer or employee of SAS, the case underscores the potential curative effect of implementing structural solutions in firms, such as ethical walls, to avoid potential disqualification at the firm level.

Should Law Firms, Financial Advisors and Investment Banks be Held to Different Standards?

Courts that have addressed challenges to retention of financial advisors and investment banks do not appear to have distinguished between lawyers, on the one hand, and financial advisors and investment banks on the other. This makes sense in light of the fact that section 327 does not provide for separate standards based on the type of professional; the statute on its face applies equally to all professionals, which accords with the Bankruptcy Code's overarching policy to ensure that all professionals zealously represent the interests of the debtor's estate.

It is unclear whether courts applying a per se rule of imputation would view investment banks or financial advisors as analytically different from law firms. However, cases finding that the non-disinterestedness of a lawyer should be imputed to the entire firm base their holdings at least in part on the Model Rules of Professional Conduct, which are applicable only to lawyers. Thus, it is possible that such courts may distinguish investment

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[32] 645 B.R. 37 (Bankr. S.D.N.Y. 2022).
[33] *Id.* at 41.
[34] *Id.*
[35] *Id.* at 42.
[36] *Id.*
[37] *Id.* 43–44.
[38] *Id.* at 43.

banks and financial advisors from law firms based on a lack of analogous rules of professional conduct. Courts may also (consciously or unconsciously) hold lawyers to a higher ethical standard, given judges are lawyers themselves.

Such courts, however, have also reasoned that, "[a] firm, whether a partnership or a professional corporation, is at root an association of lawyers servicing the clients of the firm."[39] Investment banks and financial advisory firms are also arguably, at root, associations of professionals servicing clients. Therefore, though these professionals may not be governed by similar rules of professional conduct, this fact alone may not preclude a court from imputing non-disinterestedness of a particular financial advisor or investment banker to their firm.

However, no court has affirmatively indicated that it would hold financial advisors or investment banks to a different retention standard than lawyers, and courts may well require the implementation of curative measures to prevent the non-disinterested professional from disqualifying their firm.

Curing Imputation of Disinterestedness

Various measures can be taken by professional firms to prevent or lower the risk of disqualification due to the imputation of non-disinterestedness of one of their employees. These include implementing ethical walls, disclosing such connections to the Bankruptcy Court, considering resignation of the professional from the conflicting position if unavoidable, and the "Alix Protocol."

Ethical Walls

Though many courts have declined to impute a professional's non-disinterestedness to their firm, these same courts generally require that firms put in place ethical walls to prevent any involvement of the non-disinterested professional in the debtor's case.[40] One Bankruptcy Court noted that, in order to be adequate, the ethical wall must include specific segregation mechanisms, including:

> (1) denial of access to the files or documents relating to the case in question; (2) prohibition of any discussion of the case in the presence of the screened attorneys; (3) the disqualified attorneys receive no fees or share of the fees derived from the case; and (4) the screening mechanisms were established at the time the firm took the case.[41]

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[39] *In re Michigan Interstate Ry. Co.*, 32 B.R. 327, 330 (Bankr. E.D. Mich. 1983); *see also In re Essential Therapeutics*, 295 B.R. at 210 (citing *In re Michigan Interstate Ry.* for this proposition in imputing non-disinterestedness).

[40] *See, e.g.*, *In re YMCA*, 570 B.R. at 68; *In re Sea Island Co.*, 2010 WL 4386855, at *4; *In re Timber Creek, Inc.*, 187 B.R. at 244.

[41] *In re Chicago S. Shore & S. Bend R.R.*, 101 B.R. 10, 14 (Bankr. N.D. Ill. 1989); *see also In re Sea Island*, 2010 WL 4386855, at *3–4 (citing *Chicago South Shore* for the requirements for an ethical wall).

Disclosure

As noted above, Federal Rule of Bankruptcy Procedure 2014 subjects professionals retained by the debtor to strict disclosure requirements.[42] Adequacy of disclosure under Rule 2014 is critical and "goes to the heart of the integrity of the bankruptcy system."[43] Applicants must disclose all connections regardless of whether they rise to the level of a disqualifying interest under section 327(a).[44] Furthermore, an applicant's duty to disclose connections is ongoing throughout the duration of the bankruptcy case.[45] While "the disclosure requirements may not be so onerous as to require the party to raise with the court every imaginable conflict which may occur in the bankruptcy," the disclosure requirements in Rule 2014 are broader than the rules governing disqualification under section 327(a).[46]

The Bankruptcy Court is not the only party concerned with disclosure — the U.S. Trustee's office recently announced that "it is the [U.S. Trustee's] position that relevant bankruptcy law requires professional firms to disclose on the public record their connections to a case."[47]

Additionally, failure to disclose may not only result in the disqualification of a professional or firm but may also lead to sanctions. Courts have broad discretion to order remedies for failure to disclose, which can include the reduction, denial or disgorgement of fees.[48]

Resignation

If curative measures like ethical walls are deemed insufficient to prevent or cure the imputation of non-disinterestedness to an entire firm, as a last-ditch effort, the non-disinterested individual could also resign from their non-disinterested position.[49]

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[42] *See* "Bankruptcy Code Requirements for Debtor's Retention of Professionals" *supra*.
[43] *See In re eToys, Inc*., 331 B.R. 176, 187 (Bankr. D. Del. 2005).
[44] *In re Source Enters., Inc.*, No. 06-11707 (AJG), 2008 Bankr. LEXIS 940, at *8 (Bankr. S.D.N.Y. Mar. 27, 2008) ("The term 'connections' is broad and strictly construed . . . The existence of an arguable conflict must be disclosed if only to be explained away.").
[45] *See In re eToys, Inc.*, 331 B.R. at 187.
[46] *Id.* at 191 (internal quotation marks omitted); *see also In re Am. Int'l Refinery, Inc.*, 676 F.3d 455, 465 (5th Cir. 2012).
[47] *See* Dep't of Justice, *Memorandum, Principles to Guide USTP Enforcement of Duty of Professionals to Disclose Connections to a Bankruptcy Case Under 11 U.S.C. §§ 327 and 1103 and Fed. R. Bankr. P. 2014*, (Dec. 4, 2019), https://www.justice.gov/ust/file/generalprinciplesdisclosureconflicts.pdf/download.
[48] *See In re NNN 400 Capitol Ctr. 16 LLC*, No. 16-12728, 2019 Bankr. LEXIS 2485, at *7 (Bankr. D. Del. Aug. 9, 2019), *aff'd*, No. 21-816-CFC, 2022 U.S. Dist. LEXIS 35116 (D. Del. Mar. 24, 2022) ("the failure to disclose is an independent ground for disqualification and/or disgorgement of fees").
[49] *See In re Timber Creek, Inc.*, 187 B.R. 240, 244 (Bankr. W.D. Tenn. 1995) (permitting retention of a law firm where a partner of the firm, who served on the board of the debtors, agreed to step down from the debtors' board). However, if a court finds that an employee and/or the entire firm is not disinterested but allows the firm to cure the issue through resignation, a court may nevertheless not allow the firm to retain any fees paid during the period when the firm and/or the employee was not disinterested, and the firm may only be entitled to fees from and after the time the firm is found to be disinterested. *See In re eToys, Inc*., 331 B.R. at 192 (requiring disgorgement of fees related to certain matters within the bankruptcy prior to the resignation as counsel to party adverse from the debtors in other proceedings).

The "Alix Protocol"

Additionally, the so-called "Alix Protocol," which addresses situations where a debtor seeks to retain a financial advisory firm after having retained a chief restructuring officer ("CRO"), or similar officer prepetition from the same firm, may be instructive. Even though the CRO would fail to be disinterested under section 327, the U.S. Trustee has agreed that such financial advisory firms may seek retention under section 363(b) instead of section 327, and the firm then furnishes the CRO to the debtor as part of the firm's services.[50] Firms retained under the Alix Protocol also must file relationship disclosures, along with monthly staffing reports with the Bankruptcy Court.[51] Critically, the firm may wear only "one hat" — it may not advise the debtor in more than one capacity and may not switch to be retained in a different capacity as, for example, "a financial advisor, crisis manager, claims agent, or investor."[52]

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[50] *See* Dep't of Justice, *Protocol for Engagement of Jay Alix & Associates and Affiliates*, (Aug. 11, 2014), https://www.justice.gov/sites/default/files/ust/legacy/2014/08/11/J_Alix_Protocol_Engagement.pdf. (the "Alix Protocol Memo").

[51] *In re Nine West Holdings, Inc.*, 588 B.R. 678, 688 (Bankr. S.D.N.Y. 2018) (summarizing the Alix Protocol requirements).

[52] *Id.* at 688; *see also* Alix Protocol Memo.