

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE: §
§
CHARTWELL HEALTHCARE, INC., § CASE NO. 398-38546-SAF-7
§
DEBTOR. §

MEMORANDUM OPINION AND ORDER

John H. Litzler, the Chapter 7 trustee for Chartwell Healthcare, Inc. (Chartwell trustee), moves the court pursuant to 11 U.S.C. §327(e) for an order authorizing him to employ Jean Crandall and Reyna, Hinds & Crandall (RHC) as special co-counsel to assist him with litigation matters related to the adversary proceeding styled Litzler v. Boyes, adv. no. 99-3376, civil action no. 3:99CV2448-D. Diane G. Reed, the chapter 7 trustee for East Texas Healthcare Inc., et al (Chartwell subsidiaries' trustee), supports the application. Heller Healthcare Finance, Inc., the successor in interest to HCFP Funding, Inc., the D & O defendants,¹ and 22 Acquisition Corp. oppose the application.

¹The D & O defendants are persons named as defendants in the Chartwell trustee's complaint in adversary proceeding no. 99-3376. They are Donald R. Inglehart, Jr., Irving D. Boyes, Shirley A. Salkeld, Gregory N. Boyes, Kay Brown, Michael J. Lively, and Stephen K. Morehead. Inglehart, Boyes, Salkeld, Boyes, and Morehead object to the Chartwell trustee's retention of RHC as special counsel.

The court held hearings on the application on November 2 and November 14, 2000.

A determination of whether a trustee may hire a professional person constitutes a core matter over which this court has jurisdiction to enter a final order. 28 U.S.C. §§157(b)(2)(A) & (O) and 1334. This memorandum opinion contains the court's findings of fact and conclusions of law. Bankruptcy Rules 7052 and 9014.

Section 327 governs employment of professional persons by the trustee.

Section 327(a) provides, in pertinent part:

Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys . . . that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

Section 327(c) provides:

In a case under chapter 7, 12, or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.

Litzler, however, requests authorization to employ RHC under §327(e). In

the briefs submitted to the court, Heller, the

D & O defendants, and 22 Acquisitions rely on §327(e) and cases

interpreting §327(e). Section 327(e) provides:

The trustee, with the court's approval, may

employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.

Neither Crandall nor RHC have represented the debtor. Accordingly, §327(e) does not apply.²

RHC represents the East Texas Noteholders, creditors of the Chartwell subsidiaries, one of whom also has a claim against Chartwell. Consequently, the court analyzes the trustee's application under §327(a) and (c). Under §327(c), once a creditor has objected to the application, the court must determine whether there is an actual conflict of interest that would bar RHC's employment by the Chartwell trustee. As explained below, RHC has an actual conflict of interest which prevents RHC from being employed by the Chartwell trustee to work on Litzler v. Boyes, adv. no. 99-3376, civil action no. 3:99CV2448-D.

RHC represents the East Texas Noteholders, creditors who hold claims based on notes executed by various Chartwell

²If §327(e) applied, as found below, RHC cannot satisfy the requirement set forth in §327(e) that an attorney hired by the trustee for a special purpose not "represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed."

subsidiaries. RHC represented some of the noteholders in a lawsuit against the D & O defendants. That lawsuit was resolved pursuant to a confidential settlement agreement.

RHC is representing these same noteholders in Reed v. Heller Healthcare Finance, Inc., adv. no. 99-3273. In that adversary proceeding, the trustees of Chartwell and its subsidiaries are suing Heller and the East Texas Noteholders to determine the extent and priority of the liens they assert, to avoid security interests claimed by the East Texas Noteholders pursuant to 11 U.S.C. §544(a)(1), and to avoid security interests claimed by Heller and the East Texas Noteholders because the funds to which the creditors' liens attached have been commingled with unencumbered funds. The East Texas Noteholders assert cross-claims and third-party claims against Heller, Complete Care Services, Inc., and 22 Acquisitions, seeking damages for pre-petition actions taken against the debtors.

In Litzler v. Boyes, the Chartwell trustee is suing the directors and officers listed in footnote 1 above, alleging breach of fiduciary and other duties. He contends:

The hiring of RHC allows the Chartwell Healthcare bankruptcy estate to circumvent, at least partially, the failure by the former officers and directors of Chartwell Healthcare to produce all of the books and financial records of Chartwell Healthcare and the Chartwell subsidiaries. Given the need to proceed forward with the D & O Litigation, the hiring of RHC is both cost-effective and beneficial to the Chartwell Healthcare

bankruptcy estate.

Memorandum in Support of Trustee's Application for the Retention of RHC as Special Co-Counsel, at 2. The D & O defendants oppose the trustee's application. They refer to a consulting arrangement which they allege was agreed to in principle, but not signed, incident to the confidential agreement settling the East Texas Noteholders' suit against the officers and directors. According to the consulting agreement, Crandall agreed, inter alia, to consult with the officers and directors on any future claims which may arise out of the note transactions. The agreement contained a clause recognizing that the consultation would disqualify Crandall and RHC from representing others against the directors and officers. Indeed, some of the directors and officers were sued in state court based on claims by other noteholders. The officers and directors approached Crandall, seeking consultation. Crandall declined to represent them, asserting that the consultation agreement was not binding.

The directors and officers assert that notwithstanding Crandall's unilateral decision to not execute the consultation agreement, RHC should be bound by its terms. The D & O defendants cite no authority for that proposition. While the consultation agreement may have been an integral element of the settlement agreement between the East Texas Noteholders and the officers and directors, Crandall never signed it. Moreover, RHC does not

represent the officers and directors and therefore does not owe them a duty to abstain from representing their adversaries.

The D & O defendants assert that Crandall has knowledge of the consideration given to her clients in their settlement with the officers and directors. The D & O defendants assert that, at some point, Crandall will be bound by the representation of the trustee to divulge this information so that the Chartwell trustee can evaluate settlement offers from the D & O defendants. Heller also asserts that the existence of the agreement bars Crandall from representing the Chartwell trustee in this D & O litigation.

Heller also asserts that both of the trustees' suits against the directors and officers are based on a theory that the former officers and directors of Chartwell and its subsidiaries breached their fiduciary duties on account of various transfers, including obtaining financing from the East Texas Noteholders. Heller asserts that participation in the financing could subject the East Texas Noteholders to claims for avoidance, subordination, or disallowance. Heller argues that the trustees' investigations should necessarily involve investigations of the actions of the East Texas Noteholders and that this poses a conflict for RHC. Heller notes that RHC cannot represent the Chartwell trustee effectively if its own clients are the subjects of avoidance actions. Heller also notes that the Chartwell subsidiaries' trustee maintains that the East Texas Noteholders received

payments as consultants which were improper. Heller asserts that it is impossible for RHC to defend the East Texas Noteholders against the allegations while pursuing the former officers and directors of Chartwell for making those very payments. 22 Acquisition Corp. raises similar concerns.

In post-trial briefs, Heller and 22 Acquisition raise additional concerns. Both parties in interest direct the court's attention to RHC's November 16, 2000, motion for leave to amend its cross claims and third party claims in adversary no. 99-3273, discussed above at pages 3-4. The East Texas Noteholders wish to supplement their claims against the third party defendants to assert, inter alia, a lien priority based on a single business enterprise of the second and third tier subsidiary corporations and alter ego. Heller and 22 Acquisition also direct the court's attention to footnote 1 on page 3 of the motion to amend. The footnote states: "The Trustee's counsel has indicated that he would be filing a motion for substantive consolidation. Recently, however, the Trustee indicated that he would not pursue that motion at this time." Based on the motion for leave to amend, and the footnote in particular, 22 Acquisition and Heller conclude that the affairs of Chartwell and its subsidiaries are so intertwined that RHC cannot properly represent the Chartwell trustee and the East Texas Noteholders, who are creditors of the Chartwell subsidiaries.

During the hearings, Crandall articulated that her role would be limited to helping the Chartwell trustee establish the liability of the directors and officers. As Crandall sees it, once liability is established, the trustees will take the necessary steps to allocate any recovery between the estates. However, as the attorney of creditors of the Chartwell subsidiaries, RHC owes its clients the duty of zealous advocacy. It is in the best interests of RHC's clients that the Chartwell subsidiaries benefit from any recovery against the directors and officers so that the recovery will be available for distribution to them. On the other hand, if retained by the Chartwell trustee, RHC would be obligated to him to zealously advocate for a recovery from the officers and directors for the Chartwell estate. Except for one client, RHC's noteholder clients would be harmed by a Chartwell, as opposed to a Chartwell subsidiary, recovery. Yet, if RHC zealously advocated in a manner to benefit the Chartwell subsidiaries, the Chartwell trustee would be harmed. RHC cannot avoid this actual conflict by focusing on the liability of the officers and directors. RHC cannot zealously advocate for both the noteholders and the Chartwell trustee.

Section 327(a) establishes the general standards for employment of professional persons by the trustee. See Matter of Consolidated Bancshares, Inc., 785 F.2d 1249, 1256 (5th Cir. 1986). But §327(a) applies, "[e]xcept as otherwise provided in this

section[.]” Section 327(c) provides that a professional person is not disqualified for employment under §327 solely because of the person’s representation of a creditor, unless, on an objection, “there is an actual conflict of interest.” See In re Humble Place Joint Venture, 936 F.2d 814, 819 (5th Cir. 1991).

If a professional person who has represented a creditor survives an objection under §327(c), the person still must meet the basic requirements of §327(a). See In re Arochem Corp., 176 F.3d 610, 621 (2d Cir. 1999).

RHC represents creditors of the Chartwell subsidiaries’ bankruptcy estates, one of whom is also a creditor of the Chartwell bankruptcy estate. Other creditors have objected to the employment. The court must, therefore, determine if RHC has an actual conflict of interest. If RHC does, the court must deny the application. 11 U.S.C. §327(c). If RHC does not, the court must nevertheless determine if RHC is disinterested and does not hold or represent an interest adverse to the Chartwell estate.

In order to determine what constitutes a conflict of interest, courts look to relevant state law standards. See, e.g., In re Global Marine, Inc., 108 B.R. 998, 1005 (Bankr. S.D. Tex. 1987), and cases cited therein. Rule 1.06 of the Texas Disciplinary Rules of Professional Conduct provides, in pertinent part:

(a) A lawyer shall not represent opposing parties to the same litigation.

(b) In other situations and except to the extent permitted by paragraph (c), a lawyer shall not represent a person if the representation of that person:

(1) involves a substantially related matter in which that person's interests are materially and directly adverse to the interests of another client of the lawyer or the lawyer's firm; or

(2) reasonably appears to be or become adversely limited by the lawyer's or law firm's responsibilities to another client or to a third person or by the lawyer's or law firm's own interests.

(C) A lawyer may represent a client in the circumstances described in (b) if:

(1) the lawyer reasonably believes the representation of each client will not be materially affected; and

(2) each affected or potentially affected client consents to such representation after full disclosure of the existence, nature, implications, and possible adverse consequences of the common representation and the advantages involved, if any.

Tex. Disciplinary R. Prof. Conduct 1.06, reprinted in Tex.

Gov't Code Ann., tit. 2, subtit. G, App. A. (emphasis added). The

comment to Rule 1.06 explains that

the representation of one client is "directly adverse" to the representation of another client if the lawyer's independent judgment on behalf of a client or the lawyer's ability or willingness to consider, recommend or carry out a course of action will be or is reasonably likely to be adversely affected by the lawyer's representation of, or responsibilities to, the other client.

Id. at cmt 6. RHC's representation of the Chartwell

trustee is directly adverse to its representation of the East

Texas Noteholders for two reasons. First, the Chartwell

trustee's complaint in Litzler v. Boyes contains allegations of breach of fiduciary duty by former officers and directors of Chartwell, resulting in a wasting of company assets. The complaint alleges, inter alia, poorly-structured finance plans. RHC is unlikely to be willing to consider, recommend or carry out a course of action which could expose the East Texas Noteholders for their involvement with the financing measures undertaken by the former officers and directors of Chartwell. Second, RHC cannot zealously represent the Chartwell trustee without jeopardizing its duty to maximize recovery for the East Texas Noteholders. Conversely, RHC cannot zealously represent the noteholders without jeopardizing its duty to maximize recovery for the Chartwell estate.

RHC may not rely on a waiver to absolve it of a conflict of interest. "Concepts of client consent and waiver become difficult to apply when the client, the estate, is a fiduciary for another group, the creditor body; and where the client's decisions with respect to retention of professionals, including attorneys, are subject to judicial review after disclosure, notice and hearing." In re Diamond Mortg. Corp. of Illinois, 135 B.R. 78, 90 (Bankr. N.D. Ill. 1990). The consent of the Chartwell trustee and of the East Texas Noteholders, assuming full disclosure to each noteholder client, therefore, does not preclude this court from finding

that RHC cannot represent the trustee in Litzler v. Boyes.

Even if RHC survived the objection under §327(c), RHC does not meet the requirements of §327(a). Section 327(a) provides that professional persons may be employed by the trustee if they "do not hold or represent an interest adverse to the estate" and are "disinterested persons[.]" 11 U.S.C. §327(a). Section 101(14)(E) defines a "disinterested person[.]" in pertinent part, as a person that

does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or . . . for any other reason.

The Fifth Circuit, cites with approval, 2 Collier on Bankruptcy §327.03 at 327-19, 20 (15th ed. 1985), for the proposition that:

The requirement of disinterestedness appears broad enough to include anyone who in the slightest degree might have some interest or relationship that would color the independent and impartial attitude required by the Code. . . . Indirect or remote associations or affiliations, as well as direct, may engender conflicting loyalties. The purpose of the rule is to prevent even the emergence of a conflict irrespective of the integrity of the person under consideration. . . .

Consolidated Bancshares, 785 F.2d at 1256.

The Bankruptcy Code does not define "hold or represent an interest adverse to the estate[.]" However, many courts have adopted the definition set forth in In re Roberts, 46 B.R. 815, 827 (Bankr. D. Utah 1985). According to Roberts:

To 'hold an interest adverse to the estate' means (1) to possess or assert any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant; or (2) to possess a predisposition under circumstances that render such a bias against the estate.

The policy behind requiring attorneys to be both disinterested and not hold an interest adverse to the estate is to ensure that attorneys retained under §327(a) "tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities." Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir. 1994).

RHC does not have a disqualifying connection or interest with the debtor, but RHC is not disinterested "for any other reason." The Fifth Circuit instructs that a person is not disinterested if that person has an "interest or relationship that would color the independent and impartial attitude required by the Code." Consolidated Bancshares, 785 F.2d at 1256. By virtue of RHC's attorney-client relationship with the East Texas Noteholders, the law imposes upon RHC the duty to zealously advocate its clients' interests. As counsel for the estate, RHC would owe a duty of zealous advocacy to the estate as well.

The Chartwell trustee's complaint in Litzler v. Boyes contains allegations of breach of fiduciary duty by former officers and directors of Chartwell, resulting in a wasting of company assets. The complaint alleges, inter alia, poorly-structured finance plans. RHC cannot effectively aid the Chartwell trustee in prosecuting the adversary proceeding against the former directors and officers of Chartwell because some of the allegedly improper conduct by the directors and officers is predicated on financial dealings with RHC's clients. RHC cannot be independent and impartial with respect to the conduct alleged insofar as it implicates its clients. Thus, RHC cannot meet the Fifth Circuit's standard for disinterestedness.

RHC holds an interest adverse to the estate. The Roberts case instructs that to hold an interest adverse to the estate means "to possess or assert any economic interest that would tend to lessen the value of the bankruptcy estate or that would create an actual or potential dispute in which the estate is a rival claimant[.]" Roberts, 46 B.R. at 827. By virtue of their claims, the East Texas Noteholders have an "economic interest" in the Chartwell subsidiaries' bankruptcy estates. To the extent that the Chartwell trustee, rather than the Chartwell subsidiaries' trustee, recovers from the former directors and officers of Chartwell, the assets that the Chartwell sub-sidiaries' trustee will recover for the subsidiaries' estates

will necessarily be diminished. The interest of the East Texas Noteholders in receiving a distribution from the Chartwell subsidiaries' estates pressures RHC to represent the Chartwell trustee in a manner that does not threaten their distribution from the Chartwell subsidiaries' estates. Because asserting the East Texas Noteholders' interests would "tend to lessen the value of the [Chartwell] bankruptcy estate[,]" Roberts, 46 B.R. at 827, RHC represents an interest which is adverse to the estate and cannot satisfy the requirements of §327(a).

Based on the foregoing,

IT IS ORDERED that the application of the chapter 7 trustee of the bankruptcy estate of Chartwell Healthcare, Inc., for an order authorizing the retention and employment of Reyna, Hinds & Crandall as special co-counsel is **DENIED**.

Signed this _____ day of December, 2000.

Steven A. Felsenthal
United States Bankruptcy Judge