

**BUSINESS ETHICS: DOES CONFLICTS COUNSEL SOLVE THE
PROBLEM? RECONCILING A PRACTICAL SOLUTION AND STATE
ETHICS RULES**

*28th Annual Midwestern Bankruptcy Institute
H. Roe Bartle Hall Convention Center, Kansas City, Missouri
October 3, 2008*

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**Panelists also wish to thank Kendall Wilson, J.D. 2009, Sandra Day O'Connor College of Law, Arizona State University, for his involvement in the preparation of these materials.

THE USE OF CONFLICTS COUNSEL IN RESTRUCTURING MATTERS

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I. INTRODUCTION

This article addresses the Bankruptcy Code jurisprudence concerning the ability of a law firm to represent a debtor-in-possession (a “Debtor”) or Official Committee of Unsecured Creditors (a “Committee”) in a Chapter 11 case when the firm also represents an entity that holds an interest adverse to the Debtor’s estate in unrelated matters. Specifically, it focuses on whether a firm would be disqualified under bankruptcy law from representing a Debtor when the Debtor retains separate “conflicts counsel”: a law firm retained only to handle matters or claims as to which the first firm has actual or potential conflicts of interest. In doing so, this article pays particular attention to the ethical rules in place in New York, as a Model Code jurisdiction, as it pertains to this issue.

Briefly, reported decisions interpreting the relevant provisions of the United States Bankruptcy Code, 11 U.S.C. §§ 101, *et seq.* (the “Bankruptcy Code”), have held that a firm may represent a Debtor or Committee in the above-described scenarios when the firm (i) fully discloses the extent of its relationship with the creditor as required by the Bankruptcy Code and Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”); (ii) the firm institutes an ethical wall screening those attorneys who work for the Debtor or Committee from those who provide services to the creditor in unrelated matters; (iii) the firm does not represent the Debtor or Committee in matters directly adverse to the creditor; and (iv) the Debtor or Committee retains conflicts counsel to handle any matters that are directly adverse to the creditor. The Bankruptcy Code and Rules thus would not preclude Debtor or Committee representation on this basis and courts have specifically authorized the retention of firms under these circumstances. Moreover, New York ethical rules (as well as the ethical rules in the other Model Code jurisdictions) further support this approach and analysis.

II. BACKGROUND

Major financial institutions and other creditors generally assess conflicts in restructuring matters on a case-by-case basis. Typically, these parties will not object to a law firm’s representation of a Debtor or Committee provided that: (i) the firm fully discloses the extent of its relationship with the institution as part of the bankruptcy retention process, in compliance with the requirements of the Bankruptcy Code and Bankruptcy Rules; (ii) the firm institutes an ethical wall screening those attorneys who work for the Debtor or Committee from those who provide services to the institution; (iii) the firm agrees not to represent the Debtor or Committee in matters that are directly adverse to the creditor (including the assertion of any affirmative claim against the creditor but not including normal bankruptcy matters such as use of cash collateral, obtaining debtor in possession financing and plan confirmation); and (iv) the Debtor or Committee retains conflicts counsel to handle any matters that are directly adverse to the creditor (these steps are collectively referred to herein as “Conflicts Policy”). As discussed below, even where an objection to retention is asserted, courts generally overrule the objection because such a Conflicts Policy effectively eliminates the grounds for rejection of representation under the Bankruptcy Code and Rules.

In recent years, it has become commonplace in large Chapter 11 cases for (a) a Debtor or Committee and its counsel to limit the scope of counsel’s representation to exclude matters

directly adverse to current clients of the firm and (b) the Debtor or Committee to retain conflicts counsel for those matters with respect to which primary counsel is unable to serve. Examples of cases in which these procedures have been employed and approved by the bankruptcy court include: Enron Corp. (S.D.N.Y. – Debtors and Committee); WorldCom (S.D.N.Y. – Debtors and Committee); UAL Corporation (N.D. Ill. – Debtors and Committee); Kmart (N.D. Ill. – Debtors and Committee); Ames Department Stores (S.D.N.Y. – Debtors); and Farmland (E.D. Mo - Debtors).

III. BANKRUPTCY CODE/RULES ANALYSIS

A. General Standards Governing Retention of Bankruptcy Professionals

The Bankruptcy Code sets forth a number of requirements that must be met before a Debtor or Committee may retain counsel, and also sets forth requirements for the compensation of counsel as well.¹ Section 327(a) of the Bankruptcy Code governs the retention of counsel by a Debtor. This section provides that a Debtor may, with court approval, retain counsel or other professionals “that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the [Debtor] in carrying out the [Debtor’s] duties under this title.”² Thus, Section 327(a) imposes two requirements for retention of Debtor’s counsel: such counsel must be a “disinterested person”, and must not hold or represent an interest adverse to the estate.³

The term “disinterested person” is defined in the Bankruptcy Code as a person that:

(A) is not a creditor, an equity security holder, or an insider;

(B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and

(C) 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.⁴

¹ One such requirement is imposed by Bankruptcy Rule 2014, and applies to any professional retained by a Debtor or Committee. Bankruptcy Rule 2014 requires every professional to disclose to the court in writing, *inter alia*, all of such professional’s “connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.” Fed. R. Bankr. P. 2014(a). Every professional is required to make periodic updates to this disclosure as warranted. Failure to comply with the requirements of Bankruptcy Rule 2014 can result in the disqualification of a professional, the disgorgement of fees, or both, regardless of whether the professional meets the standards for employment set forth in Sections 327(a) or 1103 of the Bankruptcy Code, and regardless of whether the undisclosed connections were materially adverse to the estate or *de minimis*. See *In re Jore Corp.*, 298 B.R. 703 (Bankr. D. Mon. 2003).

² 11 U.S.C. § 327(a).

³ In determining if retention of proposed counsel for a Debtor or Committee is warranted, courts will also look to the applicable professional rules of responsibility for guidance in analyzing conflict issues under the Bankruptcy Code. See *In re Caldor, Inc.*, 193 B.R. 165, 178 (Bankr. S.D. N.Y. 1996). This Memorandum does not address provisions of an attorney’s code of professional conduct, and is limited solely to the standards governing approval of retention under the Bankruptcy Code.

⁴ 11 U.S.C. § 101(14).

Section 1103 of the Bankruptcy Code sets forth the requirements for retention of Committee counsel. At first glance, Section 1103 does not appear to contain any restrictions on the ability of a Committee to retain counsel. It does provide, however, that counsel retained to represent a Committee may not “while employed by such committee, represent any other entity having an adverse interest in connection with the case. Representation of one or more creditors of the same class as represented by the committee shall not per se constitute the representation of an adverse interest.”⁵

The plain language of the Bankruptcy Code thus appears to impose different standards for retention of counsel by a Debtor and a Committee. Section 328 of the Bankruptcy Code, which sets forth the standards governing court approval of compensation to all estate-retained professionals, provides that the court may deny compensation to any professional retained under section 327 or 1103 if, at any time during such professional’s employment, the professional “is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed.”⁶ This wording has led some courts to conclude that the more restrictive standards set forth in Section 327(a) of the Bankruptcy Code also apply to retention of Committee counsel.⁷

It is clear from the face of the Bankruptcy Code that the standard for retention of professionals set forth in section 327(a) is more restrictive than that set forth in section 1103(b). Because the section 327(a) standard is more restrictive, however, proposed Committee counsel that meets the requirements of Section 327(a) would also meet the less restrictive requirements imposed by section 1103(b).⁸

Because the definition of “disinterested person” overlaps with the requirements of section 327(a), the two prongs set forth in section 327(a) are met if proposed counsel is a “disinterested person.”⁹ An adverse interest will be found where competing economic interests tending to diminish the estate values or to create a potential or actual dispute in which the estate is a rival claimant exist.¹⁰

A law firm’s representation of a Debtor or a Committee on the one hand and a creditor of the Debtor on the other hand may give rise to an “adverse interest” that may disqualify the firm from being retained.¹¹ Not every conceivable adverse interest, however, requires the disqualification of the law firm under section 327(a) or 1103 (b) of the Bankruptcy Code. “[M]ere hypothetical conflicts do not meet the heavy burden of proof to warrant

⁵ 11 U.S.C. § 1103(b).

⁶ 11 U.S.C. § 328(c).

⁷ See *In re Caldor, Inc.*, 193 B.R. 165, 171 (Bankr. S.D.N.Y. 1996); see also *In re Enron Corp.*, No. 01-16034(AJG), 2002 WL 32034346 (May 23, 2002, Bankr. S.D.N.Y.), *aff’d* No. 02 CIV. 5638 (BSJ), 2003 WL 223455 (February 3, 2003, S.D.N.Y.).

⁸ See *In re Caldor, Inc.*, 193 B.R. at 170-71; see also *In re Enron Corp.*, 2002 WL 32034346.

⁹ *In re Martin*, 817 F.2d 175, 179 n.4 (1st Cir. 1987); *In re Caldor, Inc.*, 193 B.R. 165, 171 (S.D.N.Y. 1996); see also *In re BH&P, Inc.*, 949 F.2d 1300, 1314 (3d Cir. 1991); *In re Leslie Fay Cos., Inc.*, 175 B.R. 525, 532 (Bankr. S.D.N.Y. 1993)

¹⁰ *In re National Liquidators, Inc.*, 182 B.R. 186, 192 (S.D. Ohio 1995); *In re TWI International, Inc. v. Vanguard Oil & Serv. Co.*, 162 B.R. 672, 675 (S.D. N.Y. 1994).

¹¹ See *National Liquidators*, 182 B.R. at 193.

disqualification.”¹² Moreover, “[h]orrible imaginings alone cannot be allowed to carry the day. Not every conceivable conflict must result in sending counsel away to lick his wounds.”¹³ Thus, an actual conflict of interest must exist before proposed counsel for a Debtor or Committee is disqualified from service.¹⁴

Closely related to the requirements of sections 327(a) and 1103(b) of the Bankruptcy Code is the disclosure requirement of Bankruptcy Rule 2014. Bankruptcy Rule 2014(a) provides:

An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to § 327, § 1103, or § 1114 of the Code shall be made only on application of the trustee or committee. The application shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States trustee. The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. *The application shall be accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.*¹⁵

Judge Gonzalez, in his decision denying a motion to disqualify Committee counsel in Enron's bankruptcy proceedings, succinctly summarized the requirements and purpose of Bankruptcy Rule 2014(a):

Rule 2014(a) requires a professional seeking an order for employment in a bankruptcy case, to submit a verified statement setting forth the professional's connections to the debtor, creditors, or any other party in interest, including their counsel and accountants. The purpose of Rule 2014 is to provide the Court (and the United States Trustee) with information to determine whether the professional's retention is in the best interests of the estate, and to maintain the integrity of the bankruptcy system. Hence, courts have ruled that Rule 2014 disclosures are to be strictly construed, and the professional must disclose all facts that bear on disinterestedness and cannot usurp the court's functions by selectively incorporating materials the professional deems important. Failure to disclose relevant connections is an independent basis for the disallowance of fees or

¹² *In re Kelton Motors, Inc.*, 109 B.R. 641, 650 (Bankr. D. Vt. 1989).

¹³ *In re Martin*, 817 F.2d 175, 183 (1st Cir. 1987).

¹⁴ *In re National Liquidators*, 182 B.R. at 193.

¹⁵ FED. R. BANKR. P. 2014 (emphasis added).

disqualification from the case. Therefore, the better practice for Rule 2014 disclosure is to err, if at all, on the side of over-disclosure.¹⁶

B. Disqualification of Firm Where Current Representation of Creditor Is On Matters Wholly Unrelated to Bankruptcy Proceeding

Application of the legal standards set forth in the Bankruptcy Code generally prohibits a law firm from representing a Debtor or Committee where an actual conflict of interest exists due to the firm's representation of an entity that is either a creditor of the Debtor, or may be subject to claims asserted by the Debtor. A number of courts have held, however, that a law firm is not disqualified from representing a Debtor or Committee if it also represents an entity with an interest adverse to the Debtor on matters wholly unrelated to the bankruptcy proceeding, especially where the firm complies with the terms of a Conflicts Policy.¹⁷

C. No Disqualification of Firm Where Prior Representation Relating to Bankruptcy Proceeding Is Terminated Before Retention By Estate

Recent decisions have held that proposed counsel for a Debtor or Committee is not disqualified due to counsel's prior representation of an entity that holds an interest adverse to the estate where counsel has established a Conflicts Policy with respect to the proposed representation. The most prominent example of this is found in *In re Enron Corp.*¹⁸ In this case, Milbank, Tweed, Hadley & McCoy LLP ("Milbank") was retained as Committee counsel.¹⁹ A creditor of one of the debtors objected to Milbank's first application for payment of interim fees and expenses and sought to disqualify Milbank as Committee counsel.²⁰ The creditor asserted that Milbank was not a disinterested person, and held interests adverse to the estates due to Milbank's prior representation of the debtors and certain financial institutions with respect to structured finance transactions.²¹ The creditor asserted that the debtors' use of structured finance transactions was one of the key factors leading to the debtors' bankruptcy filing, and all such transactions would need to be investigated to determine if the estate possessed possible claims against the financial institutions that were involved in such transactions.²²

The Court denied the creditor's objection to Milbank's fees and its motion to disqualify.²³ The Court held that disqualification was not necessary because Milbank's representation of financial institutions with respect to certain structured finance transactions ended before the Chapter 11 case was filed (even though Milbank continued to represent its financial institution

¹⁶ *In re Enron Corp.*, No. 01-16034(AJG), 2002 WL 32034346, at *5 (May 23, 2002, Bankr. S.D.N.Y.) (citations omitted), *aff'd* No. 02 CIV. 5638 (BSJ), 2003 WL 223455 (February 3, 2003, S.D.N.Y.).

¹⁷ See *In re Enron Corp.*, 2003 WL 223455 at *7; *In re Walnut Equipment Leasing Co., Inc.*, 213 B.R. 285, 291-92 (Bankr. E.D. Penn. 1997); *In re Caldor, Inc.*, 193 B.R. 165, 175 (S.D.N.Y. 1996); *Daido Steel Co., Ltd. v. Official Committee of Unsecured Creditors*, 178 B.R. 129, 131-32 (Bankr. N.D. Ohio 1995).

¹⁸ No. 01-16034(AJG), 2002 WL 32034346 (May 23, 2002, Bankr. S.D.N.Y.), *aff'd* No. 02 CIV. 5638 (BSJ), 2003 WL 223455 (February 3, 2003, S.D.N.Y.).

¹⁹ 2002 WL 32034346, at *1.

²⁰ *Id.*

²¹ *Id.* at *2.

²² *In re Enron Corp.*, No. 01-16034(AJG), 2002 WL 32034346, at *10 (May 23, 2002, Bankr. S.D.N.Y.), *aff'd* No. 02 CIV. 5638 (BSJ), 2003 WL 223455 (February 3, 2003, S.D.N.Y.).

²³ *Id.* at *13.

clients in other matters unrelated to Enron), and because Milbank had established a Conflicts Policy with the Committee when it was retained.²⁴ This policy provided that Milbank would not advise or represent the Committee with respect to the investigation of any structured finance transactions in which Milbank was engaged pre-petition, or the assertion of any claims that may be brought in connection with them.²⁵ Moreover, the Committee retained conflicts counsel to represent the Committee in those areas where Milbank was unable to provide services.²⁶ Notably, the Court reached this conclusion assuming that the “disinterested person” standard of section 327(a) applied to Milbank’s retention.²⁷ These findings were entirely affirmed by the District Court.²⁸

Another decision refused to disqualify proposed counsel on the basis of prior representations of entities with interests adverse to the estate where counsel has some form of Conflicts Policy in place, especially when conflicts counsel is available to prosecute any actions that would result in a conflict of interest for the lead firm. *In re National Century Financial Enter., Inc.*²⁹ involved an objection of the United States Trustee to the retention of proposed counsel by two noteholder subcommittees formed within the Committee.³⁰ The trustee’s objection centered on the fact that one of the firms had previously represented one of the debtors in a matter wholly unrelated to the bankruptcy proceeding, and that counsel for each subcommittee would continue to represent certain members of the subcommittees going forward.³¹ The court overruled the objection and approved the retention of counsel because it determined that the first firm’s prior representation of the debtor ended before the petition was filed and concerned wholly unrelated matters.³² The court also found that, with respect to the firms’ continued representation of individual subcommittee members, the subcommittees had established a policy whereby a given firm would not represent the subcommittees in any matter where the interests of that firm’s clients were adverse to the subcommittee.³³ Accordingly, the Court determined that the two firms were eligible for retention by the subcommittees.³⁴

Courts have, in related contexts, refused to require that multiple, affiliated debtors each have separate counsel based upon the mere possibility that a conflict of interest may arise between them in the future. In these situations, Courts have permitted one firm to represent all of the related debtor entities, provided that conflicts counsel is retained in the event that an actual conflict of interest arises between debtor entities.³⁵ Moreover, recent decisions that have found

²⁴ *Id.* at *10–11.

²⁵ *Id.*

²⁶ *Id.* at 10.

²⁷ *See id.* at *8–11.

²⁸ *See* 2003 WL 223455.

²⁹ 298 B.R. 112 (Bankr. S.D. Ohio 2003).

³⁰ *Id.* at 115.

³¹ *Id.*

³² *Id.* at 117.

³³ *In re National Century Financial Enter.*, 298 B.R. 112, 118 (Bankr. S.D. Ohio 2003).

³⁴ *Id.*; *see also id.* at 123 (wherein the court denied a motion to disqualify local counsel for Committee on the basis that counsel represented defendant in adversary proceeding filed by debtor because counsel terminated that representation before retention by Committee and would not be involved in matters relating to adversary).

³⁵ *See In re Adelphia Communications Corp.*, 336 B.R. 610 (Bankr. S.D.N.Y. 2006) (finding that, 3 ½ years after multiple debtor cases filed and creditors were initiating lawsuits relating to disputes arising from interdebtor claims, Debtor’s counsel was prohibited from taking any public position concerning disputes and had to maintain strict neutrality), *aff’d* 342 B.R. 122 (S.D.N.Y. 2006); *In re Gilbertson Restaurants, LLC*, No. 04-00385, 2004 WL

counsel not to be “disinterested persons”, or to hold interests adverse to the estate, have all involved situations where counsel either did not comply with the disclosure requirements of the Bankruptcy Code and Bankruptcy Rules, or did not follow the Conflicts Policy.³⁶

Based on the foregoing, Bankruptcy Courts will approve the retention of Debtor or Committee counsel even if counsel represented an entity having an interest adverse to the estate, provided that counsel’s representation of the adverse interest holder with respect to such interest terminated before it was retained by the Debtor or Committee, and counsel has a Conflicts Policy in place that limits the scope of its representation so that counsel does not become involved in matters directly relating to the prior representation. Of equal import, it appears that no court has disqualified counsel for a Debtor or Committee where: (i) counsel has fully disclosed the extent of its relationship with the creditor as required by the Bankruptcy Code and Bankruptcy rules; (ii) the firm instituted an ethical wall screening those attorneys who work for the Debtor or Committee from those who provided services to the creditor; (iii) the firm agreed not to represent the Debtor or Committee in matters directly adverse to the creditor; and (iv) the Debtor or Committee retained conflicts counsel to handle any affirmative claims that may be asserted against the creditor.

IV. LIMITING THE SCOPE OF REPRESENTATION AND SHOWING DEFERENCE TO CLIENT’S CHOICE OF COUNSEL

A limited representation with retention of conflicts counsel and the establishment of an ethical wall should eliminate the ethical conflict issues. Case law and other authorities support the proposition that an attorney and client can agree to limit the scope of representation to avoid conflicts of interest. Rule 1.2 of the ABA MODEL RULES OF PROFESSIONAL CONDUCT (“Model Rules”), which specifically addresses the issue of scope of representation, supports the principle of defining a representation so that it excludes matters on which a law firm has conflicts. Rule 1.2 provides that a lawyer may limit the objectives of the representation if the client consents after consultation. The RESTATEMENT OF THE LAW (THIRD) GOVERNING LAWYERS (“Restatement”) further supports the view that lawyers can often avoid conflicts by carefully limiting the range of services they agree to provide when accepting new engagements.

Federal and state courts also have recognized that the client-lawyer relationship is in large measure contractual and generally rests upon mutual consent both as to its existence and its

1724878 (May 3, 2004, Bankr. N.D. Iowa) (overruling creditor objection to motion to retain same counsel to represent multiple related debtors on basis that no actual conflict existed at time of retention and that conflicts counsel could be retained in the future if possible conflict between individual debtor entities became actual conflict).

³⁶ See *In re Etoys, Inc.*, 331 B.R. 176 (Bankr. D. Del. 2005) (requiring disgorgement of fees earned by debtor’s counsel with respect to services provided where actual conflict existed between debtor and creditors, and counsel did not disclose its relationship with those creditors as required by Bankruptcy Rule 2014); *In re Bruno*, 327 B.R. 104 (Bankr. E.D.N.Y. 2005) (denying former litigation counsel’s request for payment of fees for services performed when counsel had to withdraw from representation due to undisclosed, actual conflict of interest); *In re Jore Corp.*, 298 B.R. 703 (Bankr. D. Mon. 2003) (disqualifying counsel for debtor where counsel failed to properly disclose full extent of conflict waiver limitations negotiated with debtor’s largest secured creditor as required by Bankruptcy Rule 2014); *In re Essential Therapeutics, Inc.*, 295 B.R. 203 (Bankr. D. Del. 2003) (denying application to retain counsel for debtor because partner at firm had served as an officer of the debtor within two years before the petition date, and thus firm could not be a “disinterested person” by definition).

scope.³⁷ Accordingly, a law firm and a Debtor should be able to define the scope of the firm's representation so that it excludes matters on which it has conflicts, provided that the Debtor and Bankruptcy Court approve this arrangement after full disclosure.³⁸ Courts have also recognized that public policy favors allowing clients to choose counsel of their choice, and thus courts are reluctant to deprive a client of autonomy in choosing its counsel.³⁹

A. The Bankruptcy Code Permits Client and Counsel to Limit the Scope of Counsel's Representation

Courts interpreting the Bankruptcy Code have specifically found that it allows for counsel to represent parties for a limited purpose. 11 U.S.C. § 327(e) provides that

“[t]he trustee . . . may employ, *for a specified special purpose*, . . . 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.*”

Although the plain language of this subsection applies to a narrow set of circumstances (representation of a trustee after previous representation of a debtor), courts will apply it by analogy to other instances of limited-scope representation. In *In re Arochem Corp.*⁴⁰, Wells was a creditor who helped Harris obtain financing to found Arochem.⁴¹ After the company was forced to file a Chapter 7 petition, Harris sued Wells for failing to perform his duties as an advisor.⁴² Wells retained the law firm of Caddell & Chapman for his defense.⁴³ Later, the trustee sought to retain Caddell to pursue claims against certain creditors on a contingency basis.⁴⁴ The defendants in the trustee's action objected to the retention, arguing that Caddell had a conflict of interest because of its previous representation of Wells.⁴⁵ Wells, they argued, was not only an unsecured creditor of the estate, but also a potential target of other claims that the trustee might pursue.⁴⁶

The bankruptcy court approved the representation.⁴⁷ It analyzed the issue under section 327(e), and found that, because Caddell was retained for a specific and limited purpose as to which it had no conflict of interest, retention was proper.⁴⁸ The Second Circuit disagreed with

³⁷ See *Heine v. Colton, Hartnick, Yamin & Sheresky*, 786 F. Supp. 360, 365-66 (S.D.N.Y. 1992); *Practical Offset, Inc. v. Davis*, 404 N.E.2d 516, 520 (Ill. App. 1980).

³⁸ See *In re Fondiller*, 15 B.R. 890, 892 (9th Cir. BAP 1981); Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York, Formal Op. 2001-3 (July 2001).

³⁹ See, e.g., *In re Caldor*, 193 B.R. 165, 170 (Bankr. S.D.N.Y. 1996); *In re Heck's, Inc.*, 83 B.R. 410, 416 (S.D. W.Va. 1988); see also *In re Bohack Corp.*, 607 F.2d 258, 263 (2d Cir. 1979).

⁴⁰ 176 F.3d 610 (2d Cir. 1999).

⁴¹ *Id.* at 614.

⁴² *In re Arochem, Corp.*, 176 F.3d 610, 614 (2d Cir. 1999).

⁴³ *Id.* at 615.

⁴⁴ *Id.* at 615-16.

⁴⁵ *Id.* at 616.

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.* at 622.

the bankruptcy court's analysis; section 327(e), it held, should not have been applied to a situation where trustee's counsel had represented a creditor, since the plain language only applies to previous representation of the debtor.⁴⁹ Nevertheless, the court still upheld the representation, holding that "in applying section[] 327(a) . . . we should reason by analogy to 327(e)."⁵⁰ Thus, "where the trustee seeks to appoint counsel only as 'special counsel' for a specific matter, there need only be no conflict between the trustee and counsel's creditor client with respect to the specific matter itself."⁵¹ The court also found that, in the "unlikely event" that the trustee did decide to pursue claims against Wells, the estates could secure separate conflicts counsel for that purpose.⁵²

This case is significant for several reasons. For one thing, the court (albeit in dictum) gave its blessing to the use of conflicts counsel to cure a conflict of interest. But more generally, it held that the Code permits the employment of special counsel for a specific, limited purpose, beyond the specific situations laid out in subsection 327(e). Other courts have followed the *Arochem* court's reasoning. A recent district court decision, citing *Arochem*, specifically held that the statutory canon *expressio unius est exclusio alterius* does not preclude retention of special counsel in circumstances not specified in section 327.⁵³ Because conflicts counsel is merely a particular type of limited, "special" counsel, these cases demonstrate that the Code will permit retention of special counsel for the limited purpose of pursuing claims as to which general counsel has a conflict of interest.

B. The Model Rules Support the Principle That No Conflict Arises if the Representation is Defined to Exclude Matters on Which a Law Firm Has Conflicts

Ethical Rule 1.2 of the Model Rules, which specifically addresses the issue of scope of representation, supports the principle of defining a representation so that it excludes matters on which a law firm has conflicts. Rule 1.2(c) provides: "A lawyer may limit the scope of the representation if limitation is reasonable under the circumstances and the client gives informed consent."⁵⁴ The comment to Rule 1.2 explains that "[t]he scope of services to be provided by a lawyer may be limited by agreement with the client or by the terms under which the lawyer's services are made available to the client. . . . In addition, the terms upon which representation is undertaken may exclude specific means that might otherwise be used to accomplish the client's objectives."⁵⁵ More than forty states (though not New York) have relied on the Model Rules to fashion rules of professional responsibility for attorneys practicing in their states, and courts in other states have relied on the Model Rules as persuasive authority.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.* at 626.

⁵³ *In re Innomed Labs, LLC*, No. 02 B 22644 (ASH), 07 Civ. 4778 (WCC), 2008 U.S. Dist. LEXIS 7017, at *20 (Jan. 28, 2008 S.D.N.Y.).

⁵⁴ MODEL RULES OF PROF'L CONDUCT R. 1.0(e) (2002) defines "informed consent" to mean that the lawyer "has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct." Different states may have slightly varying language in the Model Rules as adopted in those jurisdictions.

⁵⁵ MODEL RULES OF PROF'L CONDUCT R. 1.2 cmt. 6 (2002).

C. *The Restatement of the Law (Third) Governing Lawyers Demonstrates That Lawyers Can Often Avoid Conflicts by Limiting the Range of Services They Agree to Provide*

The Restatement further supports the view that lawyers can often avoid conflicts by carefully limiting the range of services they agree to provide when accepting new engagements.⁵⁶ Section 19 of the Restatement provides:

- (1) Subject to other requirements stated in this Restatement, a client and lawyer may agree to limit a duty that a lawyer would otherwise owe to the client if:
 - (a) the client is adequately informed and consents; and
 - (b) the terms of the limitation are reasonable in the circumstances.⁵⁷

The comment to § 19 of the Restatement notes that an effective limitation on a lawyer's duty to a client must meet the following five-step "reasonableness" inquiry:

- (1) it must inform the client of any significant problems a limitation might entail;
- (2) it must be construed from the perspective of the reasonable client;
- (3) the fee charged by the lawyer must remain reasonable in view of the limited representation;
- (4) any changes made an unreasonably long time after the representation begins must meet the Restatement's tests for post-inception contracts and modifications; and
- (5) the terms of the limitation must in all events be reasonable in the circumstances.⁵⁸

D. *Additional Authorities Recognize that the Scope of the Representation is a Matter of Agreement Between the Attorney and the Client*

Case law supports the proposition that the client-lawyer relationship is, in large measure, contractual and generally rests upon mutual consent, both as to its existence and its scope.⁵⁹ Accordingly, a lawyer and a client can agree that the lawyer will handle only certain types of

⁵⁶ See RESTATEMENT OF THE LAW (THIRD) GOVERNING LAWYERS § 121 (2000), cmt. c(iii) ("Some conflicts can be eliminated by an agreement limiting the scope of the lawyer's representation if the limitation can be given effect without rendering the remaining representation objectively inadequate.").

⁵⁷ *Id.* § 19.

⁵⁸ See RESTATEMENT OF THE LAW (THIRD) GOVERNING LAWYERS § 19 cmt. c (2000).

⁵⁹ See *Practical Offset, Inc. v. Davis*, 404 N.E.2d 516, 520 (Ill. App. 1980); *Heine v. Colton, Hartnick, Yamin & Sheresky*, 786 F. Supp. 360, 365-66 (S.D.N.Y. 1992) ("[u]nder New York law, 'the relationship of an attorney and client is contractual, and the rules governing contract formation determine whether such a relationship has been created'") (quoting *Hashemi v. Shack*, 609 F. Supp. 391, 393 (S.D.N.Y. 1984)).

claims and not others.⁶⁰ Similarly, a lawyer and client can agree that the lawyer will represent the client on a specific transaction without assuming any general duties to the client beyond the sufficiency of the relevant documents.⁶¹

Other authorities also recognize that the scope of the representation is a matter of agreement between the attorney and the client.⁶² The Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York recognized that a lawyer can agree with her client to limit the scope of representation to avoid conflicts with present or former clients:

We conclude that a representation may be limited [in scope] to eliminate adversity and avoid a conflict of interest, as long as the lawyer's continuing representation of the client is not so restricted that it renders her counsel inadequate and the client for whom the lawyer will provide the limited representation consents to the limitation. In obtaining consent from the client, the lawyer must adequately disclose the limitations on the scope of the engagement and the matters that will be excluded.⁶³

The debtor client must consent to this limited representation, and court approval will be required by bankruptcy law.

E. Clients Should be Free to Choose Counsel of Their Choice

Public policy favors allowing clients to choose counsel of their choice, and thus courts are reluctant to deprive a client of autonomy in choosing its counsel.⁶⁴ The principle of client autonomy, and the fact that an attorney and client are generally free to define the scope and objectives of the representation as they wish, support a debtor's choice of counsel and the ability to limit of debtor's counsel's representation for conflicts matters.⁶⁵

⁶⁰ See, e.g., *Bergman v. The New England Ins. Co.*, 872 F.2d 672, 675 (5th Cir. 1989) ("legal relationship of attorney and client is purely contractual and results only from the mutual agreement and understanding of the parties concerned") (quoting *Delta Equipment & Constr. Co. v. Royal Indem. Co.*, 186 So. 2d 454, 458 (La. App. 1966)).

⁶¹ See, e.g., *Grand Isle Campsites, Inc. v. Cheek*, 249 So. 2d 268, 273 (La. App. 1971).

⁶² See, e.g., 1 RONALD E. MALLIN & JEFFREY M. SMITH, *LEGAL MALPRACTICE* § 8.2, at 408–09 (3d ed. 1989) (scope of representation may be limited by agreement); William T. Barker, *Defense Attorneys and Policy Limits Settlement Offers: Another View*, 1990 BAD FAITH L. REP. 141, 142 ("[T]he scope of the representation . . . is a matter of agreement between the attorney and the client(s)").

⁶³ Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York, Formal Op. 2001-3 (July 2001); see also *In re Fondiller*, 15 B.R. 890, 892 (B.A.P. 9th Cir. 1981) (conflicts can be avoided by limiting the scope of representation).

⁶⁴ See, e.g., *In re Caldor*, 193 B.R. 165, 170 (Bankr. S.D.N.Y. 1996) ("Public policy favors permitting parties to retain professionals of their choice."); *In re Heck's, Inc.*, 83 B.R. 410, 416 (S.D. W.Va. 1988) ("It has long been held that 'the relationship between attorney and client is highly confidential, demanding personal faith and confidence in order that they may work together harmoniously. Only in the rarest of cases should the [client] be deprived of selecting his own counsel'"); see also *In re Bohack Corp.*, 607 F.2d 258, 263 (2d Cir. 1979) ("We have indeed been loathe to separate a client from his chosen attorney where the alleged misconduct does not prejudice an opposing party and taint the litigation in which he is appearing.").

⁶⁵ There are common sense limits to agreements restricting the scope of representation, and such agreements may not materially impair the client's rights. See, e.g., *Hayes v. Eagle-Picher Industries, Inc.*, 513 F.2d 892, 893 (10th Cir. 1975); *Giles v. Russell*, 567 P.2d 845, 850 (Kan. 1977). Under the Model Rules, the lawyer's ability to limit the scope of the representation is bounded by the lawyer's obligation to provide competent representation. See

V. CURING CONFLICTS OF INTEREST BY EMPLOYMENT OF CONFLICTS COUNSEL

A. *New York/Model Code Analysis*

Under New York ethics law, a law firm can: (1) limit the scope of its representation of a Debtor or Committee so that the representation excludes matters on which the firm has potential conflicts (in effect, preventing a conflict from arising in the first instance); and/or (2) employ conflicts counsel and/or establish ethical walls to eliminate potential conflicts of interest.

On the related disqualification subject, which often implicates ethical rules, the Second Circuit has established alternative guidelines for courts to follow on a motion to disqualify an attorney for adverse representation, depending on the particular facts of the case.⁶⁶ The most stringent alternative, known as the “*prima facie*” rule,⁶⁷ applies to situations where a law firm undertakes to represent two adverse parties and the relationship between the firm and the clients is continuing. In such a situation, the adverse representation is *prima facie* improper. The Second Circuit has established a less stringent standard for cases of vicarious or attenuated representation, or where the potentially improper relationship is not a continuing one. In this situation, disqualification is warranted only where there is a substantial relationship between the subject matters of the past and present representations.⁶⁸ Under this “substantial relationship” test, an important issue is whether the attorney whose disqualification is sought had access to, or was likely to have had access to, relevant privileged information in the course of the prior representation.⁶⁹ Notably, the Second Circuit disqualification guidelines apply only where an adverse representation is found to exist.

Courts have recognized that “special counsel” and ethical walls can ameliorate or eliminate a conflict if it would otherwise exist. Courts appear to be willing to recognize these measures as satisfactorily eliminating or neutralizing conflicts, particularly in large scale bankruptcies where conflicts issues are prevalent. While there are few specific case holdings,

MODEL RULES OF PROF'L CONDUCT R. 1.2 (noting that the limitation must be reasonable under the circumstances.). See also N.Y. City Bar. Op. 2001-3 (the lawyer's continuing representation of the client must not be so restricted that it renders his counsel inadequate). The limitation on a law firm's scope of representation would not leave the client without professional legal assistance if conflicts counsel is engaged, and the client's interest would be protected.

⁶⁶ See *Glueck v. Jonathan Logan, Inc.*, 653 F.2d 746, 749 (2d Cir. 1981); *Hartford Accident and Indemnity Co. v. RJR Nabisco, Inc.*, 721 F. Supp. 534, 538 (S.D.N.Y. 1989).

⁶⁷ The “*prima facie*” rule is also known as the “*per se*” rule of disqualification, but the “*per se*” description is misleading because disqualification is not automatically mandated. Where the representation of the original client is a continuing one, the rule simply shifts the burden to the attorney opposing disqualification to demonstrate that there is no actual or apparent conflict in loyalties or diminution in the vigor of his representation. If the attorney meets this burden, the party seeking disqualification must then show that the challenged representation has tainted the trial by affecting counsel's presentation of the case, by placing counsel in a position to use privileged information, or by otherwise allowing counsel to gain an unfair advantage against the other side. See *University of Rochester v. G.D. Searle & Co., Inc.*, No. 00-CV-6161L B, 2000 WL 1922271, at *5-6 (W.D.N.Y. Dec. 11, 2000); see also *Cinema 5, Ltd. v. Cinerama, Inc.*, 528 F.2d 1384, 1387 (2d Cir. 1976).

⁶⁸ See *Hartford Accident and Indemnity Co. v. RJR Nabisco, Inc.*, 721 F. Supp. 534, 539 (S.D.N.Y. 1989)

⁶⁹ See *In re Wingspread Corp.*, 152 B.R. 861, 865 (Bankr. S.D.N.Y. 1993).

there is strong authority supporting the proposition that a conflict of interest can be cured or eliminated through the employment of conflicts counsel.⁷⁰

1. New York Professional Responsibility Law Is the Most Applicable Law.

This section focuses on New York law because trust indentures and many credit agreements generally provide that they are governed by New York law, and because many major bankruptcies tend to be filed in New York. The conclusions discussed here would likely not be different under the law of other jurisdictions, however. New York is a Model Code State, but a similar result would be reached under Model Rules jurisdictions, applying ER 1.7 standards for current client conflicts.

Attorneys practicing in the Southern District of New York must adhere to the NEW YORK CODE OF PROFESSIONAL RESPONSIBILITY (“Code” or “New York Code”) adopted by the Appellate Division of the New York Supreme Court.⁷¹ Canon 5 of the New York Code states that “[a] lawyer should exercise independent professional judgment on behalf of a client,” while Disciplinary Rule 5-105 of the Code proscribes a lawyer from representing a client if that representation is adverse to the interests of another existing client unless each client consents.⁷²

⁷⁰ See *In re Caldor, Inc.*, 193 B.R. 165 (Bankr. S.D.N.Y. 1996); *In re O.P.M. Leasing Services, Inc.*, 16 B.R. 932 (Bankr. S.D.N.Y. 1982); *In re Walnut Equipment Leasing Co., Inc.*, 213 B.R. 285 (E.D. Pa. 1997); *In re Guy Apple Masonry Contractor, Inc.*, 45 B.R. 160 (Bankr. D. Ariz. 1984).

⁷¹ See Local Rules of the United States District Courts for the Southern and Eastern Districts of New York, Local Civil Rules 1.3(a)(6), 1.5(b)(5) (adopting New York law for this purpose); see also *JPMorgan Chase Bank v. Liberty Mutual Insur. Co.*, 189 F. Supp. 2d 20, 22 (S.D.N.Y. 2002) (issue of disqualification in Southern District of New York is essentially governed by New York law); *NCK Organization Ltd. v. Bregman*, 542 F.2d 128, 129 n.2 (2d Cir. 1976); *Sumitomo Corp. v. J.P. Morgan & Co., Inc.*, Nos. 99 Civ. 8780(JSM), 99 Civ. 4004(JSM), 2000 WL 145747, at *2 (February 8, 2000 S.D.N.Y.).

⁷² NEW YORK CODE OF PROF’L RESPONSIBILITY DR 5-105 (2005) provides:

(a) A lawyer shall decline proffered employment if the exercise of independent professional judgment on behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment, or if it would be likely to involve the lawyer in representing differing interests, except to the extent permitted under subdivision (c) of this section.

(b) A lawyer shall not continue multiple employment if the exercise of independent professional judgment on behalf of a client will be or is likely to be adversely affected by the lawyer's representation of another client, or if it would be likely to involve the lawyer in representing differing interests, except to the extent permitted under subdivision (c) of this section.

(c) In the situations covered by subdivisions (a) and (b) of this section, a lawyer may represent multiple clients if a disinterested lawyer would believe that the lawyer can competently represent the interest of each and if each consents to the representation after full disclosure of the implementations of the simultaneous representation and the advantages and risks involved.

(d) While lawyers are associated in a law firm, none of them shall knowingly accept or continue employment when any one of them practicing alone would be prohibited from doing so under section 1200.20(a), 1200.24(a) or (b), 1200.27(a) or (b), or 1200.45(b) of this Part except as otherwise provided therein.

The New York Code embodies the principle that loyalty to the client is paramount in the attorney-client relationship.⁷³

2. Under the Model Code, An Attorney and Client Can Agree to Limit the Scope of Representation to Avoid Conflicts of Interest.

As a general matter, a law firm and a Debtor are free to define the scope and objectives of the representation as they wish, subject to the Court's approval in the case of a bankruptcy representation. This factor is the key to a representation of a Debtor which would not give rise to a conflict of interest and which would not require client consent. With Bankruptcy Court approval, the law firm and a Debtor could agree to limit the representation of the Debtor so as to avoid any conflicts with a creditor or party in interest, and allow matters related to the creditor or party in interest to be handled by another law firm retained as special counsel or conflicts counsel. The firm would therefore not be adverse to such creditor or party in interest.

3. The Second Circuit Standard Applicable to Motions to Disqualify for Adverse Representation.

While disqualification standards are not the same as the ethical rules (a violation of an ethical rule does not necessarily result in disqualification), courts often look to the ethical rules in evaluating motions to disqualify counsel for alleged conflicts of interest. The Second Circuit has established alternative guidelines regarding motions to disqualify counsel for adverse representation, depending on the particular facts of the case.⁷⁴ The limitation on the scope of the representation to exclude matters as to which a conflict exists should avoid implication of the rules described below in this section.

(e) A law firm shall keep records of prior engagements, which records shall be made at or near the time of such engagements and shall have a policy implementing a system by which proposed engagements are checked against current and previous engagements, so as to render effective assistance to lawyers within the firm in complying with subdivision (d) of this section. Failure to keep records or to have a policy which complies with this subdivision, whether or not a violation of subdivision (d) of this section occurs, shall be a violation by the firm. In cases where a violation of this subdivision by the firm is a substantial factor in causing a violation of subdivision (d) of this section by a lawyer, the firm, as well as the individual lawyer, shall also be responsible for the violation of subdivision (d) of this section.

⁷³ See *Lightman v. Flaum*, 761 N.E.2d 1027, 1032, 97 N.Y.2d 128, 135 (N.Y. Ct. App. 2001) (“a significant purpose of the Code of Professional Responsibility is to ensure ‘that attorneys remain faithful to the fiduciary duties of loyalty and confidentiality owed by attorneys to their clients’ as well as the ‘duty to deal fairly, honestly and with undivided loyalty’”) (citations omitted); *Greene v. Greene*, 391 N.E.2d 1355, 1358, 47 N.Y. 2d 447, 452 (N.Y. Ct. App. 1979) (attorney owes client the “highest duty of loyalty and professional skill in carrying on the legal action”). Also relevant is Canon 9 of the New York Code, which provides that a lawyer “should avoid even the appearance of professional impropriety.” Courts, however, are reluctant to rest a disqualification exclusively upon Canon 9 and generally require proof that another Canon has been violated. See *In re Caldor, Inc.*, 193 B.R. 165, 181 (Bankr. S.D.N.Y. 1996) (citing *Hartford Accident and Indemnity Co. v. RJR Nabisco, Inc.*, 721 F. Supp. 534, 538 (S.D.N.Y. 1989)). Canon 4, requiring the protection of client confidences, may also be relevant.

⁷⁴ See *Glueck v. Jonathan Logan, Inc.*, 653 F.2d 746, 749 (2nd Cir. 1981); *Hartford Accident and Indemnity Co. v. RJR Nabisco, Inc.*, 721 F. Supp. 534, 538 (S.D.N.Y. 1989).

a. *The Prima Facie Rule Applies to Situations Where a Law Firm Undertakes to Represent Two Adverse Parties Where the Relationship is Continuing.*

The more stringent alternative, known as the “*prima facie*” rule (sometimes also called the “*per se*” rule), applies to situations where a law firm undertakes to represent two adverse parties, both of which are “clients in the traditional sense,” and the relationship between the firm and the clients is continuing.⁷⁵ In such a situation, the adverse representation is *prima facie* improper, and the attorney must satisfy a “heavy burden” of demonstrating, “at the very least, that there will be *no actual or apparent conflict* in loyalties or *diminution in the vigor* of his representation.”⁷⁶

In Model Rules jurisdictions, the current client conflict rules in ER 1.7(a) would preclude a directly adverse representation or one in which there is a significant risk that the attorney’s representation of one client would be materially limited by the responsibilities owed to the other client. Under ER 1.7(b), however, the directly adverse representation would be permissible with informed consent and certain other conditions.

The Model Rules provide generally that a lawyer shall not represent a client if the representation would be directly adverse to another client, or if the representation would be “materially limited” by the lawyer’s responsibilities to another client or the lawyer’s own interests.⁷⁷ The rule is designed to prevent the leak of confidential information between clients as well as to avoid preferential treatment of one client over the other.⁷⁸ While most determining factors of direct adversity are judged on a case by case basis, the classic situation arises when an attorney represents a current client in a lawsuit against another current client in an unrelated matter.⁷⁹ While the risk of leaked information is minimal, the risk of the attorney favoring one party over the other is great.⁸⁰ If the attorney chooses to take on a representation directly adverse to a client in an unrelated matter, Model Rule 1.7(a) requires consent of both the current client and the other client in the unrelated matter.⁸¹ On the other hand, the rule’s use of the term “directly adverse” implies that those interests that are indirectly or generally adverse are acceptable.⁸² For example, in the case of competing businesses, a lawyer may represent both parties in their respective matters without obtaining consent from either party.⁸³ The parties are generally adverse in the sense that they operate competing businesses, but they are not directly

⁷⁵ *Glueck*, 653 F.2d at 749; *see also* *Cinema 5, Ltd. v. Cinerama, Inc.*, 528 F.2d 1384, 1387 (2nd Cir. 1976) (affirming disqualification of attorney because, when he filed the lawsuit for Cinema 5 against Cinerama, he was representing Cinerama in separate litigation).

⁷⁶ *Cinema 5*, 528 F.2d at 1387 (emphasis in original); *see also In re Wingspread Corp.*, 152 B.R. 861, 863 (Bankr. S.D.N.Y. 1993) (“When the firm concurrently represents both parties, courts are to apply a *per se* prohibition; the representation is *prima facie* improper unless the clients consent or the attorney shows, at the very least, that there will be no actual or apparent conflict in loyalties or diminution in the vigor of his representation.”) (citations omitted).

⁷⁷ Model Rules of Prof’l Conduct R. 1.7.

⁷⁸ Geoffrey C. Hazard, Jr. & W. William Hodes, 1 *The Law of Lawyering* 11-8 (Aspen Law and Business 3d 2004).

⁷⁹ *Id.* at 11-9.

⁸⁰ *Id.*

⁸¹ Gerald K. Smith, *Conflicts of Interest in Workouts and Bankruptcy Reorganization Cases*, 48 S.C. L. Rev. 793, 834 (1997).

⁸² *Id.* (citing Model Rules of Prof’l responsibility R. 1.7 cmt. 6 (2002)).

⁸³ *Id.*

adverse to one another in litigation. In yet another situation, direct litigation between large institutions may not prohibit an attorney from continuing to handle other matters in which the companies are not directly adverse. Large companies are more likely to accept the reality than in routine matters one's own attorney need not have a personal commitment in order to perform professionally.⁸⁴ A survey of legal authority, secondary sources, and industry articles reveals little discussion about the application of Model Rule 1.7 in bankruptcy proceedings with conflicts counsel. Most discussion contemplates the ethics involved when an attorney represents the debtor-in-possession and the creditor in a similar or unrelated action, either currently or previously.⁸⁵

b. The "Substantial Relationship" Test Applies for Cases of Vicarious or Attenuated Representation, or Where the Potentially Improper Relationship is Not a Continuing One.

The Second Circuit also has established "a less stringent standard for cases of vicarious or attenuated representation, or where the potentially improper relationship is not a continuing one."⁸⁶ In this situation, "disqualification is warranted only where there is a substantial relationship between the subject matters of the representation."⁸⁷ Under the "substantial relationship" test, a court must inquire "as to whether there is a substantial relationship between the subject matter of the counsel's prior representation of the moving party and the issues in the present suit[,] and whether the attorney whose disqualification is sought had access to, or was likely to have had access to, relevant privileged information in the course of his prior representation of the client."⁸⁸ In Model Rules jurisdictions, the substantial relationship test is applied to former client relationships, pursuant to ER 1.9.

If the debtor representation is limited and conflicts counsel is retained, then counsel with a potential conflict would not represent a Debtor in any matters involving counsel's prior work for a creditor relating to any of the Debtors or estates, or any matter adverse to the creditor. Those matters would be the province of conflicts counsel. As a result, counsel would not be adverse to the creditor, and there would be no relationship (substantial or otherwise) between counsel's prior representations and its new representation of a Debtor, and thus the substantial relationship test would be effectively irrelevant. The use of conflicts counsel thus could avoid the conflict entirely, no client consent would be ethically required, and the Second Circuit "*prima facie*" rule described above would be inapplicable.

4. Courts Have Approved the Use of Conflicts Counsel to Cure Conflicts.

In conjunction with limiting the scope of representation, retention of separate conflicts counsel avoids a conflict of interest. These two procedures work together: the limited scope eliminates the conflict, and separate counsel renders the limited scope reasonable because the debtor is completely represented in matters adverse to the creditor. A third concept – the ethical

⁸⁴ Hazard at 11-11.

⁸⁵ See William I. Kohn, et. al, Deciphering Conflicts of Interest in Bankruptcy Representation: An Update, 105 Com. L. J. 95, 137 (2000).

⁸⁶ Hartford Accident and Indemnity Co. v. RJR Nabisco, Inc., 721 F. Supp. 534, 539 (S.D.N.Y. 1989).

⁸⁷ *Id.*

⁸⁸ *In re Wingspread Corp.*, 152 B.R. 861, 865 (Bankr. S.D.N.Y. 1993) (citations omitted).

or information screen – ensures that creditor information is not used by the debtor. This screen should not be ethically necessary, since counsel will not handle matters relating to the creditor, but its implementation would provide further assurance that any confidential information is protected.

There is strong authority supporting the proposition that a conflict of interest can be cured through the employment of conflicts counsel. A given law firm could be retained to represent the debtor in the bankruptcy proceeding, with another law firm engaged to handle those matters as to which the first is conflicted. This procedure, of course, would have to be agreed upon by the debtor and approved by the court, after full disclosure, in a bankruptcy proceeding.

A number of courts have sanctioned the use of “special counsel” as a means of avoiding conflicts. In *In re Enron Corp.*⁸⁹, the district court affirmed the bankruptcy court’s denial of a motion to disqualify the Milbank firm based on what were alleged to be significant past and current conflicting representations.⁹⁰ After analyzing the issues under the bankruptcy “disinterested” standard, the court stated:

Bankruptcy courts also look to the Code of Professional Responsibility in analyzing conflicts of interest. Exco, therefore, alleges that Milbank should be disqualified under Canon 5 and Canon 9 of the Code of Professional Responsibility. This Court concurs with the bankruptcy court that, having found both that Milbank is not involved in any matter in which it has an adverse interest and that the use of conflicts counsel and ethical walls are appropriate, there is no basis for a violation of the Code of Professional Responsibility.⁹¹

The court found that there was no adverse interest given the engagement of conflicts counsel, quoting a N.Y. Bar Opinion to the effect that “representation may be limited to eliminate adversity and avoid a conflict of interest.”⁹²

Recently, *In re Adelpia Communications Corp.*⁹³ allowed one law firm to represent all debtor entities so long as counsel was neutral as to disputes among them.⁹⁴ During the course of the representation, a number of creditors had filed lawsuits relating to certain intercompany debts between the various entities.⁹⁵ Certain creditors sought to disqualify debtors’ counsel from representing all entities, as the interests of many of the debtors were adverse with respect to the litigation.⁹⁶ The court denied the motion, but did require debtors’ counsel to take a position of neutrality with respect to the intercompany litigation.⁹⁷ In a footnote, the court stated that this position was required of debtors’ counsel by regulation 1200.24(b) of the New York Code, which requires a lawyer to terminate multiple employment if the exercise of the lawyer’s independent judgment on behalf of one client will be adversely affected by his representation of another

⁸⁹ No. 02 CIV. 5638 (BSJ), 2003 WL 223455 (February 3, 2003, S.D.N.Y.).

⁹⁰ *Id.* at *1.

⁹¹ *Id.* at *9.

⁹² *Id.*

⁹³ 336 B.R. 610 (Bankr. S.D.N.Y. 2006), *aff’d* 342 B.R. 122 (S.D.N.Y. 2006).

⁹⁴ *Id.* at 616–17.

⁹⁵ *Id.* at 621–34.

⁹⁶ *Id.* at 671.

⁹⁷ *Id.* at 673.

client.⁹⁸ This statement appears to be *dicta*, but it does form the background for the court's ruling in the decision.⁹⁹

“Side-by-side” representational arrangements have been accepted in the bankruptcy context where conflict issues are more prevalent and courts have been willing to approve mechanisms designed to minimize conflicts of interest.¹⁰⁰

a. The Southern District of New York Has Recognized the Use of “Special Counsel” (and Firewalls) as a Means of Avoiding Conflicts of Interest: In re Caldor, Inc.

An important case supporting the use of both special counsel and firewalls to avoid conflicts of interest under New York law is the bankruptcy court’s decision in *In re Caldor, Inc.*¹⁰¹. While not holding that conflicts counsel eliminate a conflict, the court’s discussion supports this conclusion. Bradlees and Caldor were mid- to high-end discount retail

⁹⁸ *Id.* at 673 n.172.

⁹⁹ See also *In re Gilbertson Restaurants, LLC*, No. 04-00385, 2004 WL 1724878 (May 3, 2004, Bankr. N.D. Iowa) (overruled objection to retention of same counsel for multiple debtors where no actual conflict existed and conflicts counsel could be retained in the future if an actual conflict arose between debtors); *In re National Century Financial Entertainment, Inc.*, 298 B.R. 112 (Bankr. S.D. Ohio 2003) (law firm represented both creditors committees and individual creditors; objection to retention overruled where separate counsel would be retained for the committees for any matters as to which the interests of the law firm’s other clients were adverse to the committees).

¹⁰⁰ See, e.g., *In re Caldor, Inc.*, 193 B.R. 165 (Bankr. S.D.N.Y. 1996) (supporting the use of both special counsel and firewalls to avoid conflicts of interest); *In re O.P.M. Leasing Services, Inc.*, 16 B.R. 932 (Bankr. S.D.N.Y. 1982) (supporting the use of conflicts counsel to avoid a conflict of interest); *In re Walnut Equipment Leasing Co., Inc.*, 213 B.R. 285 (Bankr. E.D. Pa. 1997) (recognizing the ability of a creditors’ committee to employ special counsel to deal with a conflict of interest); *In re H & S Transp. Co.*, 53 B.R. 128, 132 (Bankr. M.D. Tenn. 1985) (recognizing that “a law firm may limit its representation so as to avoid conflicts of interest”); *In re Guy Apple Masonry Contractor, Inc.*, 45 B.R. 160, 167 (Bankr. D. Ariz. 1984) (recognizing “the ability to cure present conflicts by the appointment of a special counsel”); see also *Sumitomo Corp. v. J.P. Morgan & Co.*, Nos. 99 Civ. 8780(JSM), 99 Civ. 4004(JSM), 2000 WL 145747, at *4 (February 8, 2000 S.D.N.Y.); *In re Leslie Fay Companies, Inc.*, 175 B.R. 525, 537 (Bankr. S.D.N.Y. 1994); *In re Lee Way Holding Company*, 102 B.R. 616, 622 (S.D. Ohio 1988); *In re Blinder*, 131 B.R. 872, 880 (D. Colo. 1991).

THE RESTATEMENT OF THE LAW (THIRD) GOVERNING LAWYERS (2000) also appears to recognize that conflict-of-interest rules may be subject to change in some bankruptcy contexts. Section 128 of the RESTATEMENT, entitled “Representing Clients with Conflicting Interests,” states the general rule that “[u]nless all affected clients consent to the representation . . . a lawyer in a civil litigation may not . . . (2) represent one client to assert or defend a claim against or brought by another client currently represented by the lawyer, even if the matters are not related.” Comment c(ii) to Section 128 of the RESTATEMENT expressly recognizes that there is disagreement over the applicability of the general rule in the bankruptcy context. It states:

With respect to bankruptcy, there is substantial disagreement about whether certain types of cases or proceedings should be considered under the automatic rule of Subsection (2) or under the general rule of § 121 [prohibiting conflicts of interest] and, in general, whether conflict-of-interest rules should be changed in some instances. Tribunals must resolve such questions in light of the body of decisions developed in the specific context of bankruptcy, and often the issues are controlled by statute. *The Restatement takes no position on the applicability of Subsection (2) in the many situations that may arise in bankruptcy.*

RESTATEMENT OF THE LAW (THIRD) GOVERNING LAWYERS § 128 cmt. c(ii) (2000) (emphasis added). Obviously, limiting the scope and retaining conflicts counsel would satisfy any concerns.

¹⁰¹ 193 B.R. 165 (Bankr. S.D.N.Y. 1996)

merchandisers with Chapter 11 cases pending in the Bankruptcy Court for the Southern District of New York.¹⁰² By court order, the Bradlees Official Committee of Unsecured Creditors (the “Bradlees Committee”) retained Otterbourg, Steindler, Houston & Rosen, P.C. (“Otterbourg”) as its counsel and Ernst & Young LLP (“Ernst,” with “Otterbourg” collectively referred to as the “Professionals”), as its accountants and financial advisors. Caldor’s Official Committee of Unsecured Creditors (the “Caldor Committee,” with the Bradlees Committee collectively referred to as the “Committees”) moved pursuant to section 1103 of the Bankruptcy Code for leave to retain the same Professionals.¹⁰³ The United States Trustee (the “Trustee”) objected, arguing that under section 1103(b), the interests of the Committees were adverse because Bradlees and Caldor were competitors (competing in the same market niche), and thus the Professionals were barred from representing the Caldor Committee (regardless of the fact that Bradlees did not have a claim in and was not a party to the proceeding).¹⁰⁴ Alternatively, the Trustee contended that Otterbourg’s retention was barred under Canons 4, 5, and 9 of the New York Code of Professional Responsibility.¹⁰⁵

The Bankruptcy Court overruled the Trustee’s objection and authorized the Caldor Committee to retain the Professionals.¹⁰⁶ The court noted that the Professionals had implemented an “information barrier” to address potential conflicts of interest.¹⁰⁷ In addition, the court recognized that, as a further safeguard, special counsel could be employed to address conflicts of interest.¹⁰⁸

The court initially analyzed the retention under applicable bankruptcy law (11 U.S.C. §§ 1103, 328, 327, 101(14)), concluding that the Committees did not hold disqualifying “adverse interests” for purposes of section 1103(b) because neither the Committees nor the debtors were likely to become “rival claimants.”¹⁰⁹ The court noted that “[i]nterests are not considered ‘adverse’ merely because it is possible to conceive a set of circumstances under which they might clash.”¹¹⁰ The court thus held that “the Trustee’s assertion of a disqualifying adverse interest among the Committees is rejected as the product of ‘hypothetical conflicts’ and ‘horrible imaginings.’”¹¹¹

The court also found that Otterbourg’s retention was not barred by Canons 4, 5 or 9 of the NEW YORK CODE OF PROFESSIONAL RESPONSIBILITY.¹¹² It noted that the New York Code places the burden of maintaining and policing client confidentiality upon the attorneys in a firm, and

¹⁰² *Id.* at 168.

¹⁰³ *In re Caldor, Inc.*, 193 B.R. 165, 168 (S.D.N.Y. 1996).

¹⁰⁴ *Id.* at 170.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* at 177.

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at 171-72.

¹¹⁰ *Id.* at 172 (quoting *In re Leslie Fay Companies, Inc.*, 175 B.R. 525, 532 (Bankr. S.D.N.Y. 1994)); see also *In re Martin*, 817 F.2d 175, 183 (1st Cir. 1987) (“Horrible imaginings alone cannot be allowed to carry the day. Not every conceivable conflict must result in sending counsel away to lick his wounds.”).

¹¹¹ *Caldor*, 193 B.R. at 174. The court added that even assuming, arguendo, that the interests of the respective Committees were adverse, there was no merit to the Trustee’s objection to the retention of the Professionals because those interests did not arise “in connection with the case.” *Id.* at 174.

¹¹² *Id.* at 182. Courts look to the CODE OF PROFESSIONAL RESPONSIBILITY to analyze alleged conflicts of interest under the Bankruptcy Code. See *id.* at 178 (citation omitted).

there was no evidence that Otterbourg was unlikely or unable to fulfill its ethical responsibilities.¹¹³

The Trustee argued that Otterbourg should be disqualified from representing the Caldor Committee under Canon 4 because concurrent representation of both Committees created the possibility that Otterbourg might inadvertently disclose privileged information, obtained in representing the Caldor Committee, to the Bradlees Committee.¹¹⁴ The court rejected this argument because Otterbourg had timely implemented an “information barrier,” which involved the creation of two teams of professional employees to service the Committees.¹¹⁵ One team would render professional services to the Bradlees Committee and the other would render professional services to the Caldor Committee.¹¹⁶ By deploying the information barrier, the two teams would not consult with the same persons, work product would be retained separately, and computer files would not be inadvertently accessed.¹¹⁷ There was no evidence that Otterbourg’s Caldor team disclosed confidential information obtained in the course of representing Caldor, and thus Otterbourg had not violated Canon 4.¹¹⁸

The Trustee also argued that Otterbourg violated Canon 5, which states that “[a] lawyer should exercise independent professional judgment on behalf of a client,” and Disciplinary Rule 5-105 of the Code, which proscribes a lawyer from representing a client if that representation is adverse to the interests of another existing client unless each client consents.¹¹⁹ The Trustee contended that Otterbourg’s concurrent representation of the Committees violated Canon 5 because the interests of the Committees were adverse and because Otterbourg’s ability to represent each committee vigorously could be influenced by the dual representation.¹²⁰ The court rejected the argument, finding the Trustee’s reliance on *Cinema 5, Ltd. v. Cinerama, Inc.*¹²¹ and *Fund of Funds, Ltd. v. Arthur Andersen & Co.*¹²² misplaced.¹²³ The court explained that, in those cases, the attorneys were disqualified for directly or indirectly representing clients with adverse interests in the same, or related, litigation.¹²⁴ By contrast, the Committees were not parties to the same action and did not anticipate litigating against each other.¹²⁵ The court also found it significant that “the Caldor Committee has consented to Otterbourg’s representation of

¹¹³ *Id.* at 179.

¹¹⁴ *In re Caldor, Inc.*, 193 B.R. 165, 179 (S.D.N.Y. 1996). NEW YORK CODE OF PROF’L RESPONSIBILITY Canon 4 (2005) requires a lawyer to preserve the confidences and secrets of his client. “Confidence” refers to “information protected by the attorney client privilege under applicable law” while “secret” refers to “information gained in the professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client.” NEW YORK CODE OF PROF’L RESPONSIBILITY DR 4-101(A) (2005).

¹¹⁵ *Calder*, 193 B.R. at 177, 179. The court noted that Otterbourg deployed its “information barrier” on October 2, 1995, just five days after its selection as Committee counsel, and completed its implementation by October 10, 1995. *See id.* at 177.

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Id.* at 179.

¹¹⁹ *Id.* at 180–81.

¹²⁰ *Id.*

¹²¹ 528 F.2d 1384 (2nd Cir. 1976).

¹²² 567 F.2d 225 (2nd Cir. 1977)

¹²³ *Calder*, 193 B.R. at 180–81.

¹²⁴ *Id.*

¹²⁵ *Id.* at 181.

the Bradlees Committee and the Bradlees Committee has not objected to Otterbourg's retention in this case."¹²⁶ Accordingly, Otterbourg's disqualification was not warranted under Canon 5.¹²⁷

Finally, the court found that disqualification was not warranted under Canon 9, which provides that an attorney should avoid even the appearance of impropriety.¹²⁸ It noted that courts are reluctant to rest a disqualification exclusively upon Canon 9 and generally require proof that another Canon has been violated.¹²⁹ The court ultimately found no evidence supporting a violation of Canon 9, and, in fact, found that Otterbourg's deployment of an information barrier augmented, rather than undermined, the propriety of the dual representation.¹³⁰

While the *Caldor* Professionals did not actually employ special counsel, the court expressly recognized that such counsel may be employed to diffuse conflicts of interests. The court stated that "[i]f a conflict arises among the Committees, *either or both can retain special counsel or financial advisors, as necessary.*"¹³¹ The Trustee had argued that retaining professionals to handle discrete matters would result in unnecessary delay and costs which would be prejudicial to the creditors.¹³² The court, however, rejected the Trustee's argument because those issues would become relevant only if a disqualifying conflict arose, "which, on this record, is a remote possibility."¹³³ The court added that the problems raised by the Trustee "are far outweighed by the certain costs and delay to creditors and disruption to this case if the Professionals are disqualified at this time."¹³⁴ The court thus made clear that employment of special counsel could serve as yet a further safeguard—in addition to "information barriers"—to allow counsel for a creditors' committee to avoid a conflict of interest and comply with ethical responsibilities.

b. The Sumitomo Case: Further S.D.N.Y. Support

The decision in *Sumitomo Corp. v. J.P. Morgan & Co., Inc.*¹³⁵ also supports a law firm's ability to limit the scope of its representation to avoid a conflict of interest through the use of separate counsel (as conflicts counsel) in what could be construed as a side-by-side

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *In re Caldor, Inc.*, 193 B.R. 165, 181 (S.D.N.Y. 1996).

¹²⁹ *Id.* (citing *Hartford Accident and Indemnity Co. v. RJR Nabisco, Inc.*, 721 F. Supp. 534, 538 (S.D.N.Y. 1989)). See also *United States Football League v. NFL*, 605 F. Supp. 1448, 1452 (S.D.N.Y. 1985) (the "[m]ere appearance of impropriety will not alone serve as a sufficient basis for granting a disqualification motion. Rather, the motion will be granted only if the facts present a real risk that the trial will be tainted"). But see *Rosman v. Shapiro*, 653 F. Supp. 1441 (S.D.N.Y. 1987) (disqualifying counsel because the appearance of impropriety in its representation of one client against another was too great).

¹³⁰ *Id.* at 182. The Trustee had argued that dual representation of the Committees would create an appearance of impropriety because the Committees' interests were adverse, as demonstrated by Otterbourg's attempt to divide its bankruptcy department into two firms by use of an information barrier. *Id.* at 181–82. The court found, however, that the interests of the Committees were not adverse and the bankruptcy matters were completely separate. *Id.* at 182.

¹³¹ *Id.* at 177 (emphasis added) (citing *In re Leslie Fay Companies, Inc.*, 175 B.R. 525, 537 (Bankr. S.D.N.Y. 1994)). In *Leslie*, the bankruptcy court suggested that special counsel may be appointed to deal with conflicts of interest. See *Leslie*, 175 B.R. at 537, 539.

¹³² *Caldor*, 193 B.R. at 177.

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ Nos. 99 Civ. 8780(JSM), 99 Civ. 4004(JSM), 2000 WL 145747 (February 8, 2000 S.D.N.Y.).

representational situation. *Sumitomo* involved two actions arising from disputes regarding liability for a \$2.2 billion loss by Sumitomo Corporation (“Sumitomo”) from copper trading transactions.¹³⁶ Sumitomo brought the first action against The Chase Manhattan Bank (“Chase”); Sumitomo brought the second action two months later against J.P. Morgan & Co., Inc. (“J.P. Morgan”), Morgan Guaranty Trust Company of New York (“Morgan Guaranty”) and one Murphy (collectively “Morgan”).¹³⁷

The law firm of Paul, Weiss, Rifkind, Wharton & Garrison (“Paul Weiss”) was Sumitomo’s long-time U.S. counsel and had begun representing Sumitomo in connection with Sumitomo’s copper trading business in late 1995.¹³⁸ In June 1996, Sumitomo’s chief copper trader, Hamanaka, confessed to unauthorized copper trading, and Sumitomo publicly disclosed that it had suffered billions in losses.¹³⁹ Sumitomo retained Paul Weiss to investigate Hamanaka’s activities, to represent Sumitomo against regulatory and law enforcement authorities investigating these activities, and to defend it in any litigation arising from Hamanaka’s copper trading.¹⁴⁰

During Sumitomo’s investigation of Hamanaka’s trading activities, it received demands for payments on transactions of which it claimed to have been unaware.¹⁴¹ Sumitomo sent letters to dozens of major financial institutions, including Chase and J.P. Morgan, reserving its rights in connection with all copper-related litigation.¹⁴² When Paul Weiss discovered that several of its clients, including Chase, were among Sumitomo’s potential adversaries, it advised Sumitomo that it could not represent Sumitomo in connection with any future litigation with those clients.¹⁴³

Two years later, when Ocean View (a Paul Weiss client) sued Sumitomo, Sumitomo selected Kronish, Lieb, Weiner & Hellman LLP (“Kronish Lieb”) to handle the Ocean View action.¹⁴⁴ Paul Weiss continued to represent Sumitomo in various matters arising from Hamanaka’s activities.¹⁴⁵ In late summer of 1998, Sumitomo retained Kronish Lieb to evaluate potential claims against Chase (just as Sumitomo had selected Kronish Lieb to handle the Ocean View action).¹⁴⁶

On June 2, 1999, Sumitomo (represented by Kronish Lieb) initiated the Chase action.¹⁴⁷ Two months later, on August 10, 1999, Sumitomo (represented by Paul Weiss) filed the Morgan

¹³⁶ *Sumitomo Corp. v. J.P. Morgan & Co., Inc.*, Nos. 99 Civ. 8780(JSM), 99 Civ. 4004(JSm), 2000 WL 145747, at *1 (February 8, 2000 S.D.N.Y.).

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.* at *2.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

action.¹⁴⁸ Chase moved to disqualify Paul Weiss from representing Sumitomo in the Morgan action and to consolidate the Chase action and the Morgan action for pretrial purposes pursuant to Rules 24(a) and 42(a) of the Federal Rules of Civil Procedure.¹⁴⁹ The court granted Chase's motion to consolidate but denied the motion to disqualify.¹⁵⁰ In so doing, the district court appeared to recognize Paul Weiss' ability to limit the scope of its representation of Sumitomo to avoid a conflict of interest with Chase (Paul Weiss' client in unrelated matters) through the use of separate counsel.¹⁵¹

The district court first addressed Chase's motion to disqualify Paul Weiss from representing Sumitomo in the Morgan action. Chase first argued that disqualification was appropriate because the consolidation of the Chase action and the Morgan action would create an impermissible conflict of interest, as Paul Weiss' representation of Sumitomo would involve Paul Weiss representing one client who was suing another client in a consolidated action.¹⁵² Second, Chase argued that even if the two actions were not consolidated, disqualification was warranted because, although Chase was not a party to the litigation in which Paul Weiss was representing Sumitomo, Paul Weiss' representation would adversely affect Chase.¹⁵³ Chase thus argued that Paul Weiss' representation of Sumitomo created a conflict of interest in violation of the New York Code.

Noting that motions for disqualification are disfavored in the Second Circuit because disqualification of counsel impinges on a party's right to employ counsel of choice, the court stated that such motions are often interposed for tactical purposes.¹⁵⁴ Thus, "although doubts should be resolved in favor of disqualification, a party seeking disqualification must meet a high standard of proof before disqualification will be granted."¹⁵⁵ The court emphasized that disqualification is only appropriate if there is a significant risk that an attorney's conduct will taint the trial.¹⁵⁶

The court then evaluated Paul Weiss' conduct under Canon 5 and Disciplinary Rule 5-105. Developing Canon 5 in the context of simultaneous representation of current clients, the court noted that Disciplinary Rule 5-105 forbids a lawyer from representing a client if that

¹⁴⁸ *Id.* Although the complaints for both actions were similar, three claims in the Chase action were not alleged in the Morgan action, and seven actions alleged in the Morgan action were not raised in the Chase action. *Id.* at *2 n.2. In addition, Sumitomo maintained that the actions involved different underlying transactions and relationships and would require many different witnesses. *Id.*

¹⁴⁹ *Sumitomo Corp. v. J.P. Morgan & Co., Inc.*, Nos. 99 Civ. 8780(JSM), 99 Civ. 4004(JSM), 2000 WL 145747, at *1 (February 8, 2000 S.D.N.Y.).

¹⁵⁰ *Id.*

¹⁵¹ *Id.* at *1, *4-5.

¹⁵² *Id.* at *2.

¹⁵³ *Id.*

¹⁵⁴ *Id.* at *3.

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* The district court noted that disqualification has been ordered in essentially two kinds of cases: "(1) where an attorney's conflict of interests in violation of Canon 5 of the Code undermines a court's confidence in the vigor of the attorney's representation of his client, and (2) where the attorney is at least potentially in a position to use privileged information concerning the other side obtained through prior representation in violation of Canon 4, thus giving his present client an unfair advantage." *Id.* (citation omitted).

representation will adversely affect the interests of another current client.¹⁵⁷ The court noted that “a lawyer owes a duty of undivided loyalty to his client that precludes him from doing anything adverse to a client’s interests.”¹⁵⁸

The court nevertheless found that the Code’s prohibition against simultaneous representation did not extend to the facts before it.¹⁵⁹ Paul Weiss was not representing Sumitomo against Chase in violation of DR 5-105.¹⁶⁰ Rather, Paul Weiss was representing Sumitomo against Morgan (a non-client) while Kronish Lieb was representing Sumitomo against Chase (Paul Weiss’ current client in an unrelated matter).¹⁶¹ Accordingly, the court held that “the per se rule against simultaneous representation [articulated in various New York decisions] does not require the Court to disqualify Paul Weiss.”¹⁶²

Chase had argued that DR 5-105 mandated Paul Weiss’ disqualification because the rule prohibits a lawyer from representing a client if that representation will adversely affect another current client’s interests.¹⁶³ The court noted, however, that “disqualification is only appropriate under Canon 5 where the attorney’s conflict undermines a court’s confidence in the vigor of the attorney’s representation of his client.”¹⁶⁴

The court also noted the factual circumstances surrounding Chase’s motion to disqualify, observing that the court was “not dealing with an individual client who has placed his trust in an individual lawyer for a substantial period of time.”¹⁶⁵ Rather, as the court noted:

Chase is a huge financial institution and Paul Weiss is but one of many law firms with which it does business. Moreover, the amount of business is not substantial given the size of the two institutions. Thus, there is no reason to suspect that Paul Weiss would fail to represent Sumitomo vigorously as a result of a desire to please its client Chase. Indeed, the fact that Chase has made this motion demonstrated that Chase does not believe that Paul Weiss will not vigorously represent Sumitomo.¹⁶⁶

The district court ultimately found that there was “no danger” that Paul Weiss’ participation in the case would adversely impact its representation of Chase in other matters, given that the issues involved in the present action were “totally unrelated to the issues in the

¹⁵⁷ *Id.*

¹⁵⁸ *Sumitomo Corp. v. J.P. Morgan & Co., Inc.*, Nos. 99 Civ. 8780(JSM), 99 Civ. 4004(JSm), 2000 WL 145747, at *3 (February 8, 2000 S.D.N.Y.) (citation omitted).

¹⁵⁹ *Id.* at *4.

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ *Id.* (citing *Board of Educ. of the City of New York v. Nyquist*, 590 F.2d 1241, 1246 (2d Cir. 1979)).

¹⁶⁵ *Sumitomo*, 2000 WL 145747, at *4.

¹⁶⁶ *Id.* The court added that “[o]ne can imagine a factual situation where the relationship between the lawyer and client is so extensive and the prejudice that would result to the client, if the position the lawyer advanced on behalf of the other client was accepted, is so great that there would be an appearance of impropriety.” *Id.* Chase’s motion to disqualify did not involve such a case. *Id.*

matters in which Paul Weiss represents Chase.”¹⁶⁷ The court stated that “[w]hile one can understand that Chase’s in-house counsel might be unhappy that a law firm which represents it in some matters was taking a position in litigation involving another client that, if adopted, would prejudice an argument that Chase was advancing in a separate case, that does not mean that the law firm is violating a confidence of its client or engaging in unethical conduct.”¹⁶⁸ The court thus denied Chase’s motion to disqualify, finding “that there is no indication that Paul Weiss’ conflict between Sumitomo and Chase will undermine the Court’s confidence in the vigor of Paul Weiss’ representation of either Sumitomo in the Morgan action or Chase in any unrelated matter.”¹⁶⁹

The district court in *Sumitomo* thus upheld a law firm’s ability to limit the scope of its representation through the use of separate counsel (as conflicts counsel) in a side-by-side representation. *Sumitomo* expressly approved of separate counsel to avoid a conflict of interest in related matters. The court refused to disqualify Paul Weiss even though it recognized that Paul Weiss’ representation in the Morgan case could “prejudice an argument that Chase was advancing in a separate case.”¹⁷⁰ The court implicitly recognized that this kind of positional conflict (where a law firm is advancing a position on behalf of a client in one case that is “adverse” to the position of another client in a separate lawsuit) was not barred ethically.

c. Further Case Law from the Southern District of New York Supporting the Use of Conflicts Counsel to Avoid a Conflict of Interest: In re O.P.M. Leasing Services, Inc.

The bankruptcy court’s decision in *In re O.P.M. Leasing Services, Inc.*¹⁷¹ also supports the use of conflicts counsel to avoid a conflict of interest. In *O.P.M.*, an order to show cause was brought requesting removal of a trustee of five related Chapter 11 estates, and the removal of his counsel in an adversary proceeding brought by the trustee to establish ownership rights in certain stock.¹⁷² The case involved three trustees, consisting of a single trustee and his counsel that controlled five Chapter 11 reorganization cases, and two trustees each with separate counsel presiding respectively over two Chapter 7 liquidation cases.¹⁷³ The trustee who was appointed in the personal Chapter 7 estate of one of the principals involved asserted that there would exist a conflict between the five debtors if the property were recovered.¹⁷⁴ The Bankruptcy Court for the Southern District of New York, however, refused to disqualify either the trustee or counsel, observing that the expense of separate trustees and counsel was not warranted where “the Court

¹⁶⁷ *Id.*

¹⁶⁸ *Sumitomo Corp. v. J.P. Morgan & Co., Inc.*, Nos. 99 Civ. 8780(JSM), 99 Civ. 4004(JSm), 2000 WL 145747, at *4 (February 8, 2000 S.D.N.Y.).

¹⁶⁹ *Id.* at *5. The district court’s language suggests that it not only held that Chase failed to satisfy the high standard of proof necessary for disqualification in the Second Circuit, but also that Paul Weiss was not acting unethically based on the facts presented. *See id.* at *4–5. After denying Chase’s motion to disqualify Paul Weiss, the court consolidated the Chase action and the Morgan action for pretrial purposes. *Id.* at 5. In so doing, the district court noted that “[s]uch consolidation prejudices neither Sumitomo nor Chase because it does not create a conflict of interest for Paul Weiss.” *Id.* According to the district court, a conflict did not arise “because consolidation does not merge separate lawsuits into a single action and does not make parties in one suit parties in another.” *Id.*

¹⁷⁰ *Id.* at *4.

¹⁷¹ 16 B.R. 932 (Bankr. S.D.N.Y. 1982).

¹⁷² *Id.* at 936.

¹⁷³ *Id.* at 934.

¹⁷⁴ *Id.*

[could] be called upon to protect and allocate ownership interests amongst the competing bankruptcy estates,” and that a conflict of interest could be resolved by “*the appointment of special counsel.*”¹⁷⁵

O.P.M. Leasing Services, Inc. (“O.P.M.”) had filed a voluntary petition in bankruptcy seeking reorganization under Chapter 11.¹⁷⁶ Upon the application of certain creditors who charged O.P.M. with fraud, the court approved the appointment of James P. Hassett as reorganization trustee, and O.P.M. continued to operate under the stewardship of Hassett.¹⁷⁷ The allegations of fraud that led to appointment of Hassett as trustee also led to a grand jury investigation of the activities of O.P.M. and its principals, Mordecai Weissman and Myron Goodman.¹⁷⁸ O.P.M. was a wholly owned subsidiary of Cali Trading International, Ltd., but Cali had no employees or management and maintained its “place of business” in the offices of O.P.M.¹⁷⁹ Cali was a closely held corporation that was owned 100% by Weissman and Goodman on a 50-50 basis.¹⁸⁰ Both Weissman and Goodman also filed voluntary petitions for liquidation under Chapter 7.¹⁸¹

Hassett, in his capacity as trustee of OPM, filed an involuntary petition under Chapter 11 against Cali.¹⁸² OPM claimed that Cali was indebted to it for \$134,153.98.¹⁸³ Hassett, as a party in interest, also moved for the appointment of a trustee for Cali, and, five days later, the United States Trustee appointed Hassett.¹⁸⁴ Recognizing the potential for conflict, but subduing the concern because of other overriding considerations, the U.S. Trustee concluded that should an actual conflict develop, the issue could be dealt with at that later time.¹⁸⁵ Several months later, Reisman (the Chapter 7 trustee of the estate of Weissman) sought (1) removal of Hassett as Chapter 11 trustee of Cali because of alleged conflicts between the Cali and OPM estates (including the existence of an inter-company claim between a subsidiary and parent corporation as separate reorganization cases), and (2) disqualification of Hassett’s counsel in a lawsuit commenced by Hassett as a representative of both Cali and OPM in which he sought to establish ownership rights in the stock of Jefferson Bank.¹⁸⁶ The key conflict involved whether the stock of Jefferson Bank, if recovered by Hassett, would inure to the benefit of OPM or Cali.¹⁸⁷

The court refused to remove Hassett as the trustee for Cali or disqualify his counsel from representing Cali and OPM in the consolidated adversary proceeding.¹⁸⁸ The court first rejected

¹⁷⁵ *Id.* at 939 (emphasis added) (citing *In re General Economics Corp.*, 242 F. Supp. 439, 440 n.1 (S.D.N.Y. 1965); *In re G.E.C. Securities, Inc.*, 331 F.2d 655 (2nd Cir. 1964); *In re REA Holding Corp.*, 4 B.C.D. 1249, 1251, 1254 (Bankr. S.D.N.Y. 1979), *aff’d* 2 B.R. 733. (S.D.N.Y. 1980)).

¹⁷⁶ *In re O.P.M. Leasing Services, Inc.*, 16 B.R. 932, 934 (Bankr. S.D.N.Y. 1982).

¹⁷⁷ *Id.* at 935.

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² *Id.* at 936.

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

¹⁸⁷ *Id.*

¹⁸⁸ *Id.* at 940.

the argument that Hassett's \$134,153.98 intercompany claim should disqualify him.¹⁸⁹ The fact that Hassett as Chapter 11 trustee of OPM was a creditor of Cali or the fact that Hassett as Chapter 11 trustee of Cali owned the stock of OPM did not prevent Hassett from being disinterested or constitute an impermissible conflict of interest.¹⁹⁰ Part of the court's rationale appears to be that the slight gravity of the conflict did not justify "saddl[ing] these estates with the expense of separate trustees and trustees' attorneys".¹⁹¹

With respect to the second issue, the court stated that the possibility of Hassett recovering the Jefferson Bank stock was also an insufficient basis for removal.¹⁹² The court stated that if Hassett was successful in recovering the Jefferson Bank stock, and if there was a genuine issue as to whether the Cali or OPM estates owned the stock, the court could be called upon to protect and allocate ownership interests among the competing bankruptcy estates.¹⁹³ The court also added that the apparent conflict of interest could be resolved in a number of ways, including "*the appointment of special counsel*."¹⁹⁴

The court in *O.P.M.* expressly adopted a "wait and see approach" to the conflict issue, recognizing that "[t]o act earlier in a preemptive manner could result in confusion and interruption of the orderly administration of the OPM and Cali bankruptcy proceedings and cause them to incur unnecessary great expense."¹⁹⁵ In addition to the possible effect that disqualification would have upon the various estates, the court in *O.P.M.* noted its concern with the timing of the application for disqualification, considering it to be, in part, a tactical device.¹⁹⁶

The court also refused to disqualify Hassett's counsel under Canons 5 and 9 of the CODE OF PROFESSIONAL RESPONSIBILITY.¹⁹⁷ It found that the same reasons supporting the denial of Reisman's motion to remove Hassett as trustee of Cali applied to Hassett's counsel.¹⁹⁸ In addition, there were no facts supporting allegations of a violation of the Code.¹⁹⁹ The court added that "[f]ull disclosure of potential conflicts of interest was made by counsel to its client(s) as well as to the Court, and the retention approved in each case by Hassett as representative of the respective estate and the Court."²⁰⁰ The court stated that "[a] trustee is entitled to engage attorneys of his own choice, subject to the court's approval [and] disqualification should be undertaken with considerable circumspection and reluctance as disqualification has an immediate

¹⁸⁹ *In re O.P.M. Leasing Services, Inc.*, 16 B.R. 932, 939 (Bankr. S.D.N.Y. 1982).

¹⁹⁰ *Id.*

¹⁹¹ *Id.*

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ *Id.* (citation omitted) (emphasis added).

¹⁹⁵ *Id.* The court in *O.P.M.* relied on *Katz v. Kilsheimer*, 327 F.2d 633 (2nd Cir. 1964), which had utilized a "wait and see" approach in holding that there was no prejudice to postponing an application requesting removal of a trustee and his counsel from acting for both a parent and subsidiary corporation in which a conflict was alleged, so as to allow the trial court to proceed with a soon thereafter scheduled confirmation hearing, at which time the removal motion could be renewed, if necessary (there being the possibility that the resolution of certain issues at that hearing might make the application for separate trustees moot). See *O.P.M.*, 16 B.R. at 939-40.

¹⁹⁶ *O.P.M.*, 16 B.R. at 938-39.

¹⁹⁷ *Id.* at 940.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ *Id.* at 940-41 (citation omitted).

adverse effect on the administration of a bankrupt estate and because such motions are often interposed for tactical purposes”²⁰¹

d. A Recent New York Ethics Opinion Supports a Law Firm’s Ability to Limit the Scope of Its Representation and Sets Forth Helpful Steps to Follow.

A recent formal opinion by the Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York (“Bar Committee”) supports a law firm’s ability to limit the scope of its representation to avoid a conflict of interest. In Formal Opinion 2001-3, the Bar Committee concluded that “[t]he scope of a lawyer’s representation of a client may be limited in order to avoid a conflict of interest that might result with a present or former client of the lawyer.”²⁰² In so concluding, the opinion found that the original lawyer can assist the client in retaining separate counsel to avoid a conflict by the original lawyer.²⁰³

The Bar Committee first examined the New York Code, which provides that a lawyer shall neither undertake nor continue the concurrent representation of several clients if doing so would likely involve the lawyer in representing differing interests.²⁰⁴ The Bar Committee observed that “[t]he *sine qua non* . . . for triggering of these proscriptions is the adverse nature of the lawyer’s engagement, and where there is no adversity to a present or former client, these proscriptions do not apply.”²⁰⁵ The Bar Committee explained that because the attorney-client relationship is consensual, “we see no reason why the client cannot limit the scope of the lawyer’s representation to eliminate the adversity between another client and the lawyer, and thereby avoid any conflict.”²⁰⁶

The Bar Committee’s conclusion that it is permissible to limit the scope of a lawyer’s representation of a client to avoid conflicts with other current or former clients depends on the nature and adequacy of such a limitation. Thus, “[a]lthough the nature and adequacy of the limitation necessarily will depend on the specific engagement creating the potential adversity, the limitation should be sufficient to eliminate the ‘differing interests’ that would otherwise exist.”²⁰⁷ In particular, it is important that the lawyer refrain from actions that would effectively undermine the limitation on the scope of the representation by placing the lawyer in a position

²⁰¹ *In re* O.P.M. Leasing Services, Inc., 16 B.R. 932, 941 (Bankr. S.D.N.Y. 1982).(citation omitted).

²⁰² Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York, Formal Op. 2001-3 (July 2001).

²⁰³ *Id.*

²⁰⁴ *Id.* (citing NEW YORK CODE OF PROF’L RESPONSIBILITY DR 5-105(A)-(B)).

²⁰⁵ Formal Op. 2001-3.

²⁰⁶ Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York, Formal Op. 2001-3 (July 2001). The Bar Committee explained that its decision was fortified by the RESTATEMENT OF THE LAW GOVERNING LAWYERS, which expressly approves limiting the scope of a lawyer’s representation to avoid conflicts. *Id.* (citing RESTATEMENT OF THE LAW GOVERNING LAWYERS § 121, cmt. c(iii) (2000)). In addition, the Committee noted that Rule 1.2(c) of the Model Rules of Professional Conduct also supports such a limitation on representation. *Id.* Finally, the Committee cited several cases (including bankruptcy cases) supporting the conclusion that certain potential conflicts may be avoided by limiting the scope of representation. *Id.* (citing *Interstate Properties v. Pyramid Co. of Utica*, 547 F. Supp. 178, 181 (S.D.N.Y. 1982); *In re Fondiller*, 15 B.R. 890, 892 (9th Cir. 1981); *In re H & S Trans. Co.*, 53 B.R. 128, 132 (M.D. Tenn. 1985)).

²⁰⁷ Formal Op. 2001-3.

adverse to the other client.²⁰⁸ “Although there is no prohibition against the lawyer’s recommending or otherwise assisting her client in retaining other counsel . . . there are constraints on the lawyer’s interaction with the new counsel.”²⁰⁹ Specifically, “[t]he lawyer may not assist, or otherwise participate with, new counsel in litigating against her own client.”²¹⁰ Practically speaking, this means that “the lawyer may not instruct the other lawyer or strategize on the best way to proceed or indicate which evidence already developed pertains to the case against the other client.”²¹¹ The Bar Committee thus specifically approved of the retention of separate counsel to avoid conflicts of interest.

The Bar Committee set forth several steps which effectively limit representation and avoid ethical pitfalls. Although not dispositive or exhaustive, the Bar Committee’s discussion is instructive:

- The terms of the limited engagement should be memorialized in writing, and in detail, and the rules should be communicated both to separate counsel (if any) and to the client to ensure they both fully understand the limitations on the scope of the original firm’s representation.²¹²
- Communications with separate counsel must be regulated to ensure neutrality toward (and avoid detriment to) the law firm’s other client. “[T]he overarching and guiding principle should be neutrality toward the law firm’s other client.” The original law firm should avoid any action or communication with separate counsel where the purpose is to create a detriment to the law firm’s other client.²¹³
- In representing its client in the limited representation, the law firm may take no action for the purpose of injuring its other client. The law firm, in its limited representation, “may not adduce evidence or seek discovery in order to adversely impact its other client.”²¹⁴ The Bar Committee stated that “[a]s long as the evidence is adduced for the sole purpose of assisting its client, the possibility that the same facts adduced may be exploited by another lawyer against the other client does not preclude the law firm from doing so.”²¹⁵ This is because “facts” are “inherently neutral,” and there is no “plaintiff’s evidence” or

²⁰⁸ Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York, Formal Op. 2001-3 (July 2001).

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ *Id.*

²¹² *Id.*

²¹³ *Id.* Basically, a law firm cannot circumvent a limitation on the scope of representation by acting adversely to a client “behind the scenes.”

²¹⁴ *Id.*

²¹⁵ *Id.*

“defendant’s facts.”²¹⁶ Although the same facts or evidence can be argued by one side or the other to support a position adverse to the interests of the other party, “the underlying facts or evidence are themselves unaligned.”²¹⁷ Thus, “the lawyer is free to elicit facts or evidence even though another lawyer may exploit it to the detriment of another client. Of course, it goes without saying that the lawyer may not elicit those facts for the purpose of adversely affecting his other client and may not assert that these facts are adverse to the other client.”²¹⁸

5. Conclusion: Under the Model Code, Limiting the Scope of Representation and Retaining Conflicts Counsel Should Avoid Conflicts.

The case law and secondary materials on the Model Code support the propositions that a law firm can: (1) limit the scope of its representation of a Debtor so that the representation excludes matters on which it has potential conflicts (in effect, preventing a conflict from arising in the first instance); and (2) employ conflicts counsel to eliminate potential conflicts of interest. The use of ethical walls can also be used to protect client confidences. If the conflict of interest has been eliminated, the ethical rules proscribing adverse or conflicting representation do not apply, and client agreement is ethically required only from the Debtor, which must approve the limited representation. No consent is required from the existing client because the law firm would not be adverse to the existing client and its representation of one client would not be limited by the responsibilities to the other. Bankruptcy Court approval would also be necessary for the retention.

B. Employment of Conflicts Counsel in Other Jurisdictions

1. Recognizing the Ability of a Creditors’ Committee to Employ “Special Counsel” to Deal with Conflicts of Interest: *In re Walnut Equipment Leasing Co., Inc.* (E.D. Pa. 1997).

In *In re Walnut Equipment Leasing Co., Inc.*²¹⁹, the court recognized the ability of a creditors’ committee to employ special counsel to deal with a conflict of interest, although the court’s holding did not turn on the retention of special counsel. Equipment Leasing Corporation of America (“Equipment”) and its parent company, Walnut Equipment Leasing Company, Inc. (“Walnut”) filed voluntary petitions under Chapter 11 of the Bankruptcy Code.²²⁰ The United States Trustee (“Trustee”) subsequently appointed the Official Unsecured Creditors’ Committee

²¹⁶ Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York, Formal Op. 2001-3 (July 2001).

²¹⁷ *Id.*

²¹⁸ *Id.* The Bar Committee stated that “although judging the efficacy of a particular limitation on an engagement is necessarily fact specific, there predictably are circumstances where a lawyer’s attempt to limit the scope of her engagement will be doomed.” *Id.* The Bar Committee noted, for example, that “the limitation may be inadequate to protect the client, or once limited so as to address the conflict, the lawyer’s engagement may no longer provide meaningful value to the client whose engagement is limited, or in order to advance one client’s interests, the lawyer must harm the interests of the other client.” *Id.*

²¹⁹ 213 B.R. 285 (E.D. Pa. 1997).

²²⁰ *In re Walnut Equipment Leasing Co.*, 213 B.R. 285, 286 (E.D. Pa. 1997).

(“Committee”) to represent the unsecured creditors of both debtors.²²¹ The Committee convened and elected Summit Bank as its chairperson.²²² Summit Bank was the Indenture Trustee with respect to certain debt certificates issued by the debtors.²²³ At the same meeting, the Committee voted to retain Pepper, Hamilton & Scheetz, LLP (“Pepper”) as its counsel.²²⁴ Before this decision was made, Pepper disclosed to the Committee that it was representing Summit Bank in matters unrelated to the bankruptcy cases and that, because of such representation and an “understanding” between the parties, Pepper would not sue Summit Bank or take a position adverse to it.²²⁵

The Trustee objected to Pepper’s appointment, arguing that, by virtue of the limitations imposed upon Pepper pursuant to its “understanding” with Summit Bank, Pepper represented an entity which had an “adverse interest in connection with the case,” which is prohibited under 11 U.S.C. § 1103(b).²²⁶ In response, Pepper and Summit Bank first argued that while the language of section 1103(b) precluded committee counsel from representing other entities with adverse interests in connection with these cases, it did not preclude committee counsel from representing such entities in matters unrelated to the bankruptcy case.²²⁷ Therefore, because Pepper did not currently represent Summit Bank in connection with the case (and further agreed that it would not do so in the future), they contended that section 1103(b) did not bar Pepper’s employment as committee counsel.²²⁸ Second, Pepper and Summit Bank argued that Pepper was qualified to represent the Committee under section 1103(b) because the existence of an adverse interest had not been demonstrated by the Trustee.²²⁹ They argued that if an adverse interest arises as the cases develop, special counsel could be retained by the Committee as necessary.²³⁰

The court ultimately rejected the Trustee’s argument, and expressly found merit in Pepper’s and Summit Bank’s second argument that there was no evidence in the record that Summit Bank had an interest adverse to the Committee.²³¹ The court stated that “[m]ere speculation or the potential that Summit Bank may, in the future, have an interest adverse to the Committee will not suffice to bar Pepper’s employment.”²³² The court examined the contours of Pepper’s understanding with Summit Bank and found that, based on representations made by counsel for Pepper and Summit Bank, the parties’ understanding did not impose any restriction on Pepper’s ability to advocate the will of the Committee, even where Summit Bank might take a position adverse to the Committee, so long as such action was not directed against Summit Bank

²²¹ *Id.*

²²² *Id.*

²²³ *Id.*

²²⁴ *Id.* at 287.

²²⁵ *Id.*

²²⁶ *Id.* at 288.

²²⁷ *Id.*

²²⁸ *Id.* at 289.

²²⁹ *Id.* at 288.

²³⁰ *Id.*

²³¹ *Id.* at 289.

²³² *Id.* at 290. The court noted that “interests are not considered ‘adverse’ merely because it is possible to conceive a set of circumstances under which they might clash.” *Id.* (quoting *In re Leslie Fay Companies*, 175 B.R. 525, 532 (Bankr. S.D.N.Y. 1994)). See also *In re Muma Services, Inc.*, 286 B.R. 583, 587-88 (Bankr. D. Del. 2002) (no actual conflict existed at time of retention as counsel for creditors committee; motion of indenture trustee to disqualify law firm because of subsequently arising adverse relationship was denied).

in its individual capacity.²³³ The court further stated that both counsel had also represented that the understanding did not impose any restrictions or limitations on Pepper's ability to conduct an analysis of, and draft a memorandum regarding, Summit Bank's transactions with the debtors.²³⁴ The understanding also did not prohibit Pepper from identifying issues that might require action against Summit Bank.²³⁵ Based on these representations, the court found that Pepper's representation of Summit Bank did not restrict or limit Pepper's ability to zealously perform its duty on behalf of the Committee, and thus Summit Bank did not have an interest adverse to the Committee under section 1103(b).²³⁶ The court emphasized that "the Committee has selected Pepper as its counsel of choice and, having found that Pepper's employment does not violate § 1103(b), I must honor that choice."²³⁷

The court also recognized that if an adverse interest arose in the future on the part of Summit Bank, the issue of Committee representation might arise anew. Although Judge Sigmund stated that she would not comment on the appropriateness of employing special counsel to deal with a conflict of interest in that particular case, her discussion of the issue clearly suggests that special counsel may be employed for such purpose:

I am not commenting upon whether it would be appropriate should this situation arise for the Committee to employ special counsel to handle its dealings with Summit Bank and to continue employing Pepper as its counsel for all other matters. I do advise Pepper, however, that *if it becomes necessary to either appoint special counsel to represent the Committee in its dealings with Summit Bank or appoint new counsel altogether because of Pepper's relationship with Summit Bank*, I will require Pepper to devote its time to educating and transferring the file or whatever portion of it is necessary to such counsel and will not approve compensation to Pepper for the time which it spends on the same. While the Committee should be permitted its choice of counsel, I do not believe that the debtors' estates should be forced to pay for additional attorneys' fees caused by the need to change counsel or hire special counsel when the possibility that such a situation could arise in the future is known before counsel's appointment is even approved. Pepper is fully aware that a situation could occur in which it will refuse to represent the Committee because of its representation of Summit Bank and yet it still seeks to secure its appointment as counsel for the Committee. As such, it is only fair that any additional attorneys' fees caused by the need for other counsel be borne by Pepper and not the estates. Moreover, although I am approving Pepper's employment under § 1103(b), Pepper may be denied compensation under § 328(c) if "during [its] employment under section . . . 1103 . . . [it] is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which [it] is employed." 11 U.S.C. § 328(c).²³⁸

²³³ *In re* Walnut Equipment Leasing Co., 213 B.R. 285, 291 (E.D. Pa. 1997).

²³⁴ *Id.*

²³⁵ *Id.*

²³⁶ *Id.*

²³⁷ *Id.* at 292.

²³⁸ *In re* Walnut Equipment Leasing Co., 213 B.R. 285, 292 n.7 (Bankr. E.D. Pa. 1997) (emphasis added).

This discussion clearly validates the use of conflicts counsel to avoid a conflict of interest.

2. Recognizing the Ability to Cure Conflicts by the Appointment of Special Counsel: *In re Guy Apple Masonry Contractor, Inc.* (Bankr. D. Ariz. 1984)

The bankruptcy court in *In re Guy Apple Masonry Contractor, Inc.*,²³⁹ relying on *O.P.M.*, similarly recognized “*the ability to cure present conflicts by the appointment of a special counsel.*”²⁴⁰ In *Masonry Contractor*, two fee applications had been filed by counsel for Guy Apple Masonry Contractor, the debtor in possession. Creditor Bricklayers Trust Fund (“Bricklayers”) objected to payment of compensation on the grounds that (1) counsel never obtained a court order authorizing their employment, and (2) counsel allegedly had represented conflicting interests in the proceeding.²⁴¹ Although Bricklayers did not actually request removal of counsel for the debtor, it did urge denial of the fees requested and a reexamination of interim compensation previously awarded.²⁴²

The court initially held that an order of employment was a prerequisite to awarding compensation, and that it possessed equitable power to enter a *nunc pro tunc* order of employment in an appropriate case.²⁴³ Thus, the real question before the court was whether the requirements for such approval could be met. Bricklayers asserted that counsel could not make the showings required for appointment because counsel had represented conflicting interests throughout the proceedings.²⁴⁴ The question before the court was whether or not counsel for the debtor had represented or currently represented an interest that, under 11 U.S.C. § 101(13)(E), was materially adverse to the interests of the estate, creditors, or equity security holders.²⁴⁵

Counsel’s representation of an entity named University Block, Inc. (also a debtor in bankruptcy) created a difficult question for the court because, in addition to a large prepetition debt owed to the debtor, University Block owed the debtor Masonry Contractor an undetermined amount for rent incurred as an administrative expense during the proceedings.²⁴⁶ The court noted that University Block leased its block manufacturing plant from Masonry Contractor and that such information had only been recently learned in connection with Masonry Contractor’s motion to sell assets and University Block’s motion to dismiss its Chapter 11 proceedings.²⁴⁷ Masonry Contractor’s sale application involved, among other things, the buildings in which the block manufacturing plant was housed.²⁴⁸ At around the same time that the application for sale was filed, University Block moved to dismiss its voluntary petition.²⁴⁹ University Block intended to sell certain assets to persons purchasing the block plant and equipment from Masonry Contractor.²⁵⁰ Pursuant to the motion to dismiss, University Block made arrangements to pay all

²³⁹ 45 B.R. 160 (Bankr. D. Ariz. 1984).

²⁴⁰ *Id.* at 167 (emphasis added).

²⁴¹ *Id.* at 162.

²⁴² *In re Guy Apple Masonry Contractor, Inc.*, 45 B.R. 160, 162 (Bankr. D. Ariz. 1984).

²⁴³ *Id.* at 163–64.

²⁴⁴ *Id.* at 164.

²⁴⁵ *Id.*

²⁴⁶ *Id.* at 164–65.

²⁴⁷ *Id.* at 165.

²⁴⁸ *Id.*

²⁴⁹ *In re Guy Apple Masonry Contractor, Inc.*, 45 B.R. 160, 165 (Bankr. D. Ariz. 1984).

²⁵⁰ *Id.*

creditors in full outside of bankruptcy except Masonry Contractor.²⁵¹ The court noted that both the inter-company unsecured and administrative claims created actual conflicts of interest, and that the tensions created by these conflicts were exacerbated by University Block's motion to dismiss, which (as just noted) proposed payment of all creditors except Masonry Contractor.²⁵²

Despite the fact that conflicts of interest existed, the court nevertheless held that "not all conflicts will prevent the appointment of counsel or result in disqualification, once appointed."²⁵³ Instead, conflicts of interest do not void the retention of counsel but rather make it avoidable as the facts may warrant.²⁵⁴ The court in *Masonry Contractor* relied upon the bankruptcy court's decision in *O.P.M.*, where the existence of inter-company claims did not warrant disqualification of the trustee or counsel representing related Chapter 11 corporations, because the conflict, "should it arise, might be resolved in a number of ways, including the appointment of special counsel."²⁵⁵ The court in *Masonry Contractor* noted how the *O.P.M.* court had "adopted a 'wait and see' attitude, recognizing that acting in a pre-emptive [sic] manner could disrupt the orderly administration of the estates involved."²⁵⁶

The court ultimately held that counsel's representation of University Block was not so materially adverse as to warrant withholding approval of the appointment as debtor's counsel, and thus a formal order approving retention of counsel for the debtor was not prohibited.²⁵⁷ The court noted that the most compelling reason for its decision was the fact that the debtor had proposed a plan calling for full payment of all creditors.²⁵⁸ Although the debtor's ability to pay creditors in full was contingent upon the amount of the allowed claims arising from rejection or expiration of the collective bargaining agreement, it could not be said that result was improbable or impossible, and it was difficult to see how the estate would have been prejudiced by this conduct if all creditors were paid in full.²⁵⁹ The court stated that "[t]his lack of prejudice to the

²⁵¹ *Id.*

²⁵² *Id.* at 165-66.

²⁵³ *Id.* at 166.

²⁵⁴ *Id.*

²⁵⁵ *Id.*

²⁵⁶ *Id.*

²⁵⁷ *Id.* at 166-67. The court observed that:

An overly strict interpretation of the rules regarding employment of counsel may result in the estate's loss of the benefits to be obtained by the retention of counsel familiar with the debtor's affairs. This consideration is even more important where no objection is made until late in the proceedings. . . . Conflicts of interest must be disclosed and ruled upon. The Court simply finds that at this late stage continued representation of the debtor by present counsel would be in the best interests of the estate. The major issues remaining to be resolved relate to the amount and priority of the various claims from debtor's attempted rejection of a collective bargaining agreement. Present counsel is intimately familiar with these issues and the background necessary to debtor's effective assertion of its position. It would be both counterproductive and unduly expensive at this point to require new counsel to become familiar with these files. The Court notes [that Bricklayers] has not moved for disqualification of counsel but has simply urged that compensation be denied.

Id. at 167.

²⁵⁸ *Id.*

²⁵⁹ *In re Guy Apple Masonry Contractor, Inc.*, 45 B.R. 160, 167 (Bankr. D. Ariz. 1984).

estate, coupled with the ability to solve the conflict by the appointment of special counsel, in addition to the factors cited above, leads to the conclusion a formal order approving retention of counsel is not prohibited.”²⁶⁰ The court emphasized that “[t]he primary factors involved in this determination is the lack of prejudice to the estate if the creditors are paid 100% *and the ability to cure present conflicts by the appointment of special counsel.*”²⁶¹

3. Approving a Plan to Employ Special Counsel to Cure Conflicts of Interest: *In re Rockaway Bedding, Inc.* (Bankr. D.N.J. 2007)

In *In re Rockaway Bedding, Inc.*,²⁶² the Bankruptcy Court specifically approved a plan whereby potential conflicts would be cured through the use of special conflicts counsel. Debtor Rockaway Bedding filed with the court an application for retention of Duane Morris LLP as bankruptcy counsel.²⁶³ The Office of the United States Trustee objected to Duane Morris’s retention due to its previous and ongoing representation of several of Rockaway’s pre-petition creditors, particularly PNC Bank.²⁶⁴ PNC Bank, Rockaway’s largest secured creditor, had used Duane Morris in negotiating two cash collateral orders on behalf of Rockaway.²⁶⁵ Other potential conflicts also existed, including that PNC bank constituted .68% of Duane Morris’s revenues the previous year.²⁶⁶

The court granted the application over the Trustee’s objection.²⁶⁷ Noting that “no actual conflict of interest exist[ed]”, and also noting the significant harm that the debtor would suffer if it were forced to retain new counsel,²⁶⁸ the court specifically approved Duane Morris’s proposed plan to cure any potential conflicts.²⁶⁹ The plan included a conflicts waiver executed by PNC bank; the erection of an ethical wall to prevent professionals who were providing services to the debtor from working concurrently on any matters for PNC bank; and an agreement by Duane Morris not to assert any affirmative claims against PNC Bank in connection with Rockaway’s

²⁶⁰ *Id.*

²⁶¹ *Id.* (emphasis added). Other cases, to varying degrees, also support the proposition that conflicts counsel can be employed to avoid conflicts of interest. *See, e.g., In re Leslie Fay Cos., Inc.*, 175 B.R. 525, 537 (S.D.N.Y. 1993) (special counsel or advisors may be retained, as necessary, to deal with conflicts that may arise); *In re Decor Corp.*, 171 B.R. 277, 284 (S.D. Ohio 1994) (recognizing that special counsel could be retained to avoid any potential conflicts of interest); *In re Blinder*, 131 B.R. 872, 880 (D. Colo. 1991) (recognizing that special counsel could be employed to deal with conflicts of interest and noting that “in part in recognition of the complexity of large firm practice and the substantial likelihood that conflicts will arise in any complex liquidation or bankruptcy proceeding . . . courts have permitted subsequent curative measures when a firm has faced a potential conflict due to imperfect termination of its representation of a creditor of the estate”); *In re Lee Way Holding Co.*, 102 B.R. 616 (S.D. Ohio 1988) (“in the unlikely event that a conflict arises subsequently, this can be dealt with through designation of special counsel or through counsel for the unsecured creditors’ committee, albeit at possible additional cost”); *In re O’Connor*, 52 B.R. 892, 894-95 (W.D. Okla. 1985) (conflict of interest could be resolved by appointment of special counsel); *see also* NORTON BANKRUPTCY LAW AND PRACTICE 2D § 27:13 (courts recognize the use of special counsel to deal with conflict-related claims).

²⁶² No. 07-14890, 2007 WL 1461319 (May 14, 2007 Bankr. D.N.J.).

²⁶³ *Id.* at *1.

²⁶⁴ *Id.*

²⁶⁵ *Id.*

²⁶⁶ *Id.*

²⁶⁷ *Id.*

²⁶⁸ *Id.* at *3.

²⁶⁹ *In re Rockaway Bedding, Inc.*, No. 07-14890, 2007 WL 1461319, at *2 (May 14, 2007 Bankr. D.N.J.).

bankruptcy proceedings.²⁷⁰ “If such a situation should arise,” the court noted, “Duane Morris LLP proposes to *retain separate conflicts counsel to pursue such claims.*”²⁷¹ Discussing its approval of the plan in more detail, the court stated that the “[m]ost significant[.]” factor was that “PNC Bank and the Debtors [had] executed a conflicts waiver which *specifically provides for independent representation of matters relating to fraud or misrepresentation.*”²⁷²

4. Application of the Model Rules

A current client conflict under the Model Rules is analyzed as follows:

ER 1.7. Conflict of Interest: Current Clients

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer’s responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client:

(2) the representation is not prohibited by law; and

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.²⁷³

The authorities and reasoning discussed above are instructive in applying these Rules. Where conflicts counsel is retained, ER 1.7(a)(1) is not implicated because there is no directly adverse representation. The law firm’s representation of the Debtor is not directly adverse to the existing client, since conflicts counsel handles matters relating to the existing client. ER 1.7(a)(2) is not

²⁷⁰ *Id.*

²⁷¹ *Id.* (emphasis added).

²⁷² *Id.* at *3 (emphasis added).

²⁷³ MODEL RULES OF PROF’L CONDUCT R. 1.7 (2002).

implicated because there is no significant risk of a material limitation of either representation. The law firm can continue to represent the existing client in other, unrelated matters which are irrelevant to the firm's representation of the Debtor in the bankruptcy proceeding. Likewise, the law firm's representation of the Debtor would not be affected by its representation of the existing client regarding such other matters. Any advice or actions relating to the existing client would be provided or undertaken by conflicts counsel, and not by the law firm. The concurrent representations would have no effect on the lawyer's "ability to consider, recommend or carry out an appropriate course of action for the client."²⁷⁴ There is no foreclosure of alternatives or impairment of the lawyer's independent judgment. ER 1.7(b) thus is not applicable, and the existing client's consent is not required.

VI. CONCLUSION

It is well settled that proposed counsel will not be disqualified from representing a Debtor or Committee even though it may also have an ongoing or past representation of an entity that holds an interest adverse to the estate where: (a) counsel's representation of the other entity is in matters wholly unrelated to the bankruptcy proceeding; or (b) counsel's representation of the other entity in a matter related to the bankruptcy proceedings ended prior to its retention by the Debtor or the Committee, provided that counsel implements the terms of a Conflicts Policy with respect to its representation of the Debtor or Committee. This Conflicts Policy should include a plan to retain special counsel to handle any matters or claims as to which general counsel has an actual or potential conflict of interest.

²⁷⁴ See MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 8 (2002).