Title: **Are You My Counsel? Unraveling Ethical Issues in Corporate Bankruptcy Representation**

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**Moderator:**
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Associate  
Kilpatrick Townsend & Stockton LLP  
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**Panelists:**

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Chief Legal Officer  
Kinetic Renewable Energy Services  
Chatsworth, CA

Victor A. Vilaplana  
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Kozyak Tropin Throckmorton, LLP  
Miami, FL

Frank Vazquez  
Counsel  
Chadbourne & Parke LLP  
New York, NY
Tab 1 – Biographies or CVs
Josefina Fernandez McEvoy

After 24 years in the private sector, as a practicing lawyer and consultant to development agencies and private sector firms, Ms. McEvoy joined Kinetic Renewable Energy Services DMCC as its Chief Legal Officer. In that role she is involved in virtually every aspect of the company’s business including risk mitigation, corporate governance, commercial and government compliance, M&A and divestitures, project finance, and project development, design and construction.

Ms. McEvoy has a strong ability to work in cross-cultural environments and has worked extensively in North America, Latin America, Europe, Asia, Africa and the Middle East concerning corporate, transactional and litigation matters.

She has published many articles in professional journals, contributed to books, spoken at many high profile national and international conferences on topics including financial and business restructurings, rule of law, corporate governance and anti-corruption. She has extensive experience in providing policy advice, at the highest levels, to entities and governments; and drafted several enacted legislations. She holds a J.D., M.Ed. and B.A. from Temple University
Corali Lopez-Castro concentrates her practice on bankruptcy and commercial litigation matters. Cori’s practice reflects her extensive experience and expertise with bankruptcy reorganizations and liquidations, receiverships, debt restructuring, and creditors’ rights. She has been involved with the liquidation of four significant bank holding companies in bankruptcy courts around the country and state court. Cori served on the panel of Trustees for the Southern District of Florida between 1998 and 2002, during which she was responsible for the liquidation of assets in bankruptcy cases filed in the United States Bankruptcy Court for the Southern District of Florida.

Cori has been a partner at Kozyak Tropin & Throckmorton since 1998. She was Managing Partner of the firm from 2011 through 2012. In 2014, Cori was inducted as a Fellow into the 25th Class of the American College of Bankruptcy. The College recognizes individuals for their professional excellence and contributions to the field of restructuring and insolvency.

In 2006 Cori was elected the second woman president of the Cuban American Bar Association, the largest voluntary bar association in Florida.

PERSONAL STATEMENT

I love being a lawyer. I have been involved with the Cuban American Bar Association for over twenty years. I applaud the continuing efforts of the organization to provide pro bono legal services to the Hispanic community. Helping create The Florida Bar’s “ONE” campaign to encourage lawyer participation in pro bono efforts is one of the projects of which I am most proud.

RESULTS

Bankruptcy

Cori led the team that confirmed the Chapter 11 plan of one of the largest distributors of smart phones, tablets and accessories to Latin America. The confirmation of the plan occurred within eight months of filing the petition. Cori also led the team that represented the owner of a luxury hotel in Bal Harbour, Florida. She was able to confirm a plan a year after filing the Chapter 11 case. The case had been preceded by years of litigation among the various associations with an interest in the property. She also represented the corporate owner-operator of a prestigious golf facility on the west coast of Florida. The company required a debt restructuring in the aftermath of the 2008 financial crisis and the accompanying downturn in Florida real estate values. She was instrumental in bringing about a consensual Chapter 11 plan that enabled the company to continue operations and emerge with a healthy balance sheet.

Creditors’ Rights

Many of Cori’s more successful cases/clients never see a courtroom. She has negotiated numerous workouts for corporations and high net worth individuals. She measures success by the control maintained by her clients over their businesses and the amount of the debt restructured as a result of finding consensual solutions to problems.

Receiverships

Cori has been appointed receiver and represented receivers in several cases pending in state court. She was recently appointed Special Magistrate in a partition action. As Special Magistrate, she is tasked with conducting the sale of a prominent Miami Beach hotel/condominium hybrid in a manner designed to maximize sale proceeds so that the interests of all owners are protected.

EDUCATION

J.D., cum laude, University of Miami School of Law
B.A., Brown University
Victor A. Vilaplana is of counsel and a litigation attorney with Foley & Lardner LLP. Mr. Vilaplana focuses his practice on the handling of insolvency matters, particularly complicated business bankruptcies and international transactions. His experience includes representing multiple industries with Chapter 11 cases. Mr. Vilaplana is a member of the firm’s Bankruptcy & Business Reorganizations, International, and Latin America Practices and Automotive Industry Team.

Prior to joining Foley, Mr. Vilaplana was a shareholder of Seltzer Caplan McMahon Vitek and a managing partner of the San Diego office of Sheppard, Mullin, Richter & Hampton.

Representative Experience

- Represent the Port of San Diego in connection with insolvencies of its tenants
- Represent the County of Sacramento

Education

Mr. Vilaplana is a graduate of Stanford University (J.D., 1973), George Washington University (M.A., with highest honors, 1970) and San Diego State University (B.A., with honors, 1968).

Thought Leadership

He is a frequent lecturer for the California Continuing Education of the Bar, Practicing Law Institute, Law Education Institute, and National Institute of Trial Advocacy on the topics of insolvency, uniform commercial code, and various U.S./Mexico related issues, such as real estate ownership, commercial law, equipment leasing and debtor/creditor relations. He is also an ALI-ABA lecturer on practice under the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA).

Mr. Vilaplana has authored articles on the administration of multi-national bankruptcies and prepackage Chapter 11 plans of reorganization. He is co-editor of Advanced Chapter 11
Bankruptcy Practice for the American Law Institute.

Professional Memberships

Mr. Vilaplana is a member of the American Bar Association, the American Law Institute, and the State Bar of California. He is a fellow for the American College of Bankruptcy, a delegate to UNCITRAL on various international insolvency projects, and founding member of the International Insolvency Institute.

Recognition

Mr. Vilaplana has been selected by his peers for inclusion in The Best Lawyers in America© since 1993 in the field of bankruptcy and creditor-debtor rights law. Mr. Vilaplana has also been Peer Review Rated as AV® Preeminent™, the highest performance rating in Martindale-Hubbell's peer review rating system. He was also selected for inclusion in the 2007-2016 San Diego Super Lawyers® lists and in 2013 and 2016, they ranked him as one of the Top 50 Lawyers in San Diego.

Community Engagement

Mr. Vilaplana’s community involvements include his of counsel position for the San Diego Regional Economic Development Corporation, board member for the San Diego Port Authority and the San Diego Children’s Hospital and vice president and director of the San Diego Museum of Contemporary Art.
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Francisco Vazquez is counsel in Chadbourne & Parke LLP’s New York office and a member of the firm’s bankruptcy and financial restructuring practice. Mr. Vazquez’s practice focuses on representation of foreign representatives in cross-border ancillary proceedings. He also has represented debtors in pre-packaged and conventional Chapter 11 cases, advised borrowers and lenders in out-of-court restructurings, as well as advised creditors’ committees, secured and unsecured lenders and examiners in Chapter 11 cases.

Mr. Vazquez has written on bankruptcy and cross-border issues in various publications, including The American Bankruptcy Institute Journal, Norton’s Annual Survey of Bankruptcy Law and INSOL International. Mr. Vazquez received his J.D. from St. John’s University School of Law, where he was the managing editor of the ABI Law Review. He is a member of the American Bankruptcy Institute and the Advisory Board of the ABI Law Review. He is currently an adjunct professor at St. John’s University School of Law.
**Lindsey D. Simon**
Associate
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**Services**
Litigation, Complex Commercial Litigation, Bankruptcy & Financial Restructuring

Lindsey Simon focuses her practice on corporate restructuring and complex commercial litigation matters.

Prior to joining the firm, Ms. Simon practiced at a litigation boutique firm in Chicago, Illinois where she represented corporations and individuals with business litigation, insurance, class action, and restructuring issues in state and federal court. Ms. Simon was a law clerk for the Honorable Beverly B. Martin of the U.S. Court of Appeals for the Eleventh Circuit.

While attending law school, Ms. Simon served as notes editor for the *Northwestern University Law Review*.

**Professional & Community Activities**
American Bankruptcy Institute, Member
Hispanic National Bar Association, Member

**Education**
Northwestern University School of Law, J.D., magna cum laude, Order of the Coif (2013)
Vanderbilt University, Master of Education (2008)
Vanderbilt University, Bachelor of Music, magna cum laude (2007)

**Bar Admissions**
Illinois (2014); Georgia (2016)

**Admissions**
U.S. District Court for the Northern District of Illinois
U.S. Court of Appeals for the Eleventh Circuit

**Clerkships**
Tab 2 – Course Materials (articles, publications, other materials)
Understanding the Identity of the Client

a. Different types of clients in a bankruptcy case:
   i. Debtor—Entity or individual that has filed for bankruptcy.
   ii. Creditor—Entity or individual that holds a claim against the debtor. Could be for services before the petition date or for services/goods provided after the case was filed.
   iii. Creditors’ Committee—An official group made up of a number of unsecured creditors that, as a whole, has standing to act on behalf of the entire class of unsecured creditors.
   iv. Trustee—An individual that is appointed by the court (often upon request of the parties or the United States Trustee, which is a standalone oversight entity appearing in bankruptcy cases on behalf of the Department of Justice) or elected by creditors to oversee proper administration of the bankruptcy estate.
   v. Insider/Affiliate of Debtor—Equity holder of the debtor or parent, subsidiary, or affiliate of the entity that has filed for bankruptcy.

b. What are potential conflict issues for each type of client?
   i. Debtor
      1. Multiple debtor situations (intercompany loans, transfers, etc.).
      2. Difference between representing insiders or the board versus representing the debtor company.
      4. Issues arising when the law firm is a prepetition creditor.
   ii. Creditor
      1. Issues when counsel represented other parties in interest prior to the bankruptcy.
      2. Issues that arise when representing multiple creditors.
   iii. Creditors’ Committee
      1. Conflicts between interests of committee members and interests of the estate’s unsecured creditors as a whole.
      2. Existing or evolving conflicts with individual committee members, i.e. critical vendor status, committee member pursuing litigation against the debtor, resolution of claim, etc.
   iv. Trustee
      1. Issues that arise from representing an individual, but having an obligation to act for the interest of the estate as a whole.
      2. Possible representation as special counsel.
      3. Dual representation of trustee and creditor.

2. Source of Ethical Duties Owed to the Client
   a. Bankruptcy Code:
      i. Under section 327 of the Bankruptcy Code, professionals employed in the case must not hold an interest adverse to the estate and must be disinterested.
      1. Section 101(14) defines a disinterested person as one who:
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.”

ii. Section 328 of the Bankruptcy Code addresses limitation on compensation of counsel. Notably, in the court may deny compensation if counsel is not disinterested or holds an interest adverse to the estate.

iii. Section 1103 of the Bankruptcy Code outlines duties for committee counsel representation, including an obligation to not “represent any other entity having an adverse interest in connection with the case.”

iv. Section 1104 of the Bankruptcy Code summarizes appointment of a trustee, including a requirement that the trustee be “disinterested.”

b. Federal Rules of Bankruptcy Procedure

i. Rule 2014 requires proposed counsel to disclose disinterestedness and any conflicts in an application for employment. This rule also requires counsel to update their disclosures throughout the case.

ii. Rule 2016 outlines compensation application procedures.

iii. Rule 2017 relates to excessive transfers or payments to debtor’s counsel.

c. ABA Model Rules of Professional Conduct

i. Maintain client privilege and confidentiality (Rule 1.6).

ii. Conflict of interest with current clients (Rule 1.7).

iii. Special rules for representing and organization as a client (Rule 1.13).

3. Recognizing the Potential Consequences of Conflicted Representation

a. Case-specific consequences

i. Conflicted counsel may be disqualified.

ii. Court may decide to deny fee application and/or require disgorgement of already collected fees.

b. Legal consequences

i. Client may bring malpractice action for breach of fiduciary duty.

ii. There is also a possibility of civil/criminal penalties brought by the United States Trustee.

c. Professional Organization Consequences (i.e. from the state bar)

i. Counsel may be eligible for sanctions.

ii. Counsel may be prohibited from practicing before certain courts.

iii. Counsel may be disbarred.

4. Identifying Solutions to Avoid Conflicts in Client Representation

a. Efforts to manage client expectations and educate client on proper scope of representation.

b. When to get separate or conflict counsel.

c. Disclosure to the court, in applications or elsewhere.

d. Use of bylaws to protect against potential conflicts and future committee issues.

5. Questions from the Audience and Conclusion
Ethics Issues in Representing a Chapter 11 Debtor: Resolving Conflicts of Interest

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When an attorney proposes to represent a debtor-in-possession (“DIP”) in a chapter 11 bankruptcy case, she must evaluate whether her law firm meets the qualifying tests imposed by the Bankruptcy Code, and also the applicable state professional responsibility code or rules, generally some form of the Model Rules of Professional Conduct. Often, the law firm will already represent other parties in interest in the case, resulting in conflicts of interest, or have other connections with the DIP or its owners or creditors. This paper discusses the applicable statutes, rules and case law, and steps that counsel should take to determine and attempt to resolve conflict and qualification issues, including through seeking consent from existing firm clients.

A. Disinterestedness and Lack of Any Adverse Interest.

Bankruptcy Code § 327(a) requires that counsel for the trustee not “hold or represent an interest adverse to the estate” and be a “disinterested person.” Courts have held that § 1107 imposes the same requirement on counsel for the DIP. “Disinterestedness” by definition includes a checklist of attributes for the applicant counsel, such as not being itself a creditor or equity security holder. It also requires that the applicant not personally hold an interest “materially adverse” to the estate or any class of creditors or equity holders. To that extent only it overlaps the § 327(a) requirement that the applicant not “hold” or “represent” an adverse interest.

Adverse interest has been defined broadly to mean either (i) possessing or asserting any economic interest that would tend to lessen the value of the bankruptcy estate or that would

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1 This outline is substantially adapted from Chapter 27, Ethical Responsibilities, NORTON BANKRUPTCY LAW AND PRACTICE 2D (Clark Boardman Callaghan), written by this author.
2 See In re Eagle-Picher Industries, Inc., 999 F.2d 969 (6th Cir. 1993)(§ 1107(b) exception narrow); In re Martin, 817 F.2d 175 (1st Cir. 1987); But see In re Howard Smith, Inc., 207 B.R. 236 (Bankr. W.D. Okl. 1997)(§ 1107(b) exception allows employment of creditor accountant without waiver of de minimus claim); Matter of Federated Department Stores, Inc., 20 B.C.D. 973 (Bankr. S.D. Ohio 1989) (court appointed investment banker for debtor despite failure to meet strict disinterestedness standards, holding DIP has more leeway to do so than trustee, and debtor has compelling need for professional with its qualifications; most if not all comparably qualified investment bankers have same conflicts).
4 In re Arochem Corp., 176 F.3d 610, 629 (2d Cir. 1999)(personal standard); In re BH & P., 949 F.2d 1300, 1310 (3d Cir. 1991) (same); In re Huntoe, Inc., 288 B.R. 229 (Bankr. E.D. Mo. 2002) (personal standard for disinterestedness does not apply when firm merely represents materially adverse interest; evaluate representational adversity by flexible fact-specific analysis).
create either an actual or potential dispute in which the estate would be a rival claimant, or (ii) possessing or having a predisposition under the circumstances to be biased against the estate. A number of courts have also used a disinterestedness test of whether the person “in the slightest degree might have some interest or relationship that would even faintly color the independence and impartial attitude required by the Code and the Bankruptcy Rules,” but that test was rejected by the Third Circuit as a discredited “appearance of impropriety” standard.6

The circuit courts tend to read the statutory requirements literally, when the disqualifying attribute is specifically set forth in the Code, such as being a creditor or insider.7 These cases have not dealt with facts that are difficult to justify, however, such as a law firm associate owning a few equity shares in a publicly traded debtor. When the Code does not explicitly mandate disqualification, i.e. when the issue is existence of a material adverse interest, most circuit court cases have evaluated the facts of the case from an abuse of discretion perspective, focusing on materiality of the arguably-disqualifying facts, and weighing potential difficulties against potential advantages to the estate.8 Counsel must present evidence of the likelihood the potential conflict might turn into an actual one, and the influence this conflict is likely to have on decision-making, i.e. the likelihood of material adversity.

Under Code § 327(e), special counsel need not be disinterested, and must lack a material adverse interest only with respect to the matter on which the attorney is to be employed.9 An application to employ special counsel must include sufficiently detailed

5In re Roberts, 46 B.R. 815, 826-27 (Bankr. D. Utah 1985), aff'd in part, 75 B.R. 402 (D. Utah 1987); In re Granite Partners, L.P., 219 B.R. 22 (Bankr. S.D.N.Y. 1998); see also In re Leslie Fay Companies, Inc., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994) (“... if it is plausible that the representation of another interest may cause the debtor's attorneys to act differently than they would without that other representation, then they have a conflict and an interest adverse to the estate.”); Roger J. Au & Sons v. Aetna Ins. Co. (In re Roger J. Au & Sons, 64 B.R. 600, 604 (N.D. Ohio 1986); In re Michigan General Corp., 78 B.R. 479 (Bankr. N.D. Tex. 1987).
6In re Marvel Entertainment Group, Inc., 140 F.3d 463 (3d Cir. 1998); compare In re Granite Partners, L.P., 219 B.R. 22 (Bankr. S.D.N.Y. 1998) and cases cited therein for appearance of impropriety standard. In re Prince, 40 F.3d 356 (11th Cir. 1994); U.S. Trustee v. Price Waterhouse, 19 F.3d 138 (3d Cir. 1994); In re Middleton Arms, Limited Partnership, 934 F.2d 723 (6th Cir. 1991) (court cannot use § 105 powers to disregard disinterestedness criterion); In re Pierce, 809 F.2d 1356 (8th Cir. 1987) (only Congress, not courts, can change disinterestedness requirements). In re Eagle Picher Industries, Inc., 999 F.2d 969 (6th Cir. 1993)(investment banker for outstanding securities of DIP); see also In re Park-Helena Corp., 63 F.3d 877 (9th Cir. 1995) (disclosure rules to be literally construed, even if results are harsh).
7In re Marvel Entertainment Group, Inc., 140 F.3d 463 (3rd Cir. 1998); In re Occidental Financial Group, Inc., 40 F.3d 1059 (9th Cir. 1994); In re Interwest Business Equipment, Inc., 23 F.3d 311 (10th Cir. 1994); In re Martin, 817 F.2d 175 (1st Cir. 1987); In re International Oil Co., 427 F.2d 186 (2d Cir. 1970); In re B H & P, Inc., 949 F.2d 1300 (3d Cir. 1991); In re Harold & Williams Development Co., 977 F.2d 906 (4th Cir. 1992); In re Consolidated Bancshares, Inc., 785 F.2d 1249 (5th Cir. 1986)(facts regarding alleged conflict in representing DIP and officer/director must be brought out at hearing to evaluate whether conflict exists); but see In re Freedom Solar Center, 776 F.2d 14 (1st Cir. 1985)(resolve doubts in favor if disqualification); In re W.F. Development Corp., 905 F.2d 883 (5th Cir. 1990), cert. denied 111 S.Ct. 1311 (1991)(no hearing necessary as to general partner/limited partner, since always a conflict).
8Kittay v. Kornstein, 230 F.3d 531 (2d Cir. 2000); In re Arochem Corp., 176 F.3d 610 (2d Cir. 1999); In re M.T.G., Inc. 298 B.R. 310 (Bankr. E.D. Mich. 2003); In re RPC Corp., 114 B.R. 116 (M.D.N.C. 1990) and cases cited therein; In re West Pointe Properties, L.P., 249 B.R. 273 (Bankr. E.D. Tenn. 2000); In re
disclosures to enable the court to determine whether there is such a disqualifying adverse interest.\textsuperscript{10} Attorneys cannot purport to serve as special counsel to bypass disinterestedness requirements while in fact acting as bankruptcy counsel.\textsuperscript{11} If special counsel has a conflict arising from representation of a creditor rather than prior representation of the debtor (as referenced in § 327(e)), some courts have held the attorney will be disqualified.\textsuperscript{12}

\textbf{B. Representation of Multiple, Affiliated Entities.}

Courts generally focus on the insider’s/affiliate’s status as a creditor as a key reason for disqualifying his DIP counsel as the affiliated entity’s DIP counsel. But representation of a creditor is not a disqualifying “adverse interest” unless there is “an actual conflict of interest.”\textsuperscript{13} The difference between actual and potential conflicts is discussed in the attorney ethics rules and codes, and by bankruptcy courts in the context of joint representation of affiliated DIPs.

Professional conduct rules prohibit representation of one client directly adverse to another client or materially limited by counsel’s responsibilities to another client or third person or his own interests, unless a waiver is obtained. If the lawyer reasonably believes the representation will not be adversely affected, and the clients consent after consultation, multiple representation can go forward.\textsuperscript{14} The clients who are to waive the conflict would be the related

\begin{footnotesize}
\begin{enumerate}
\item In re Maximus Computers, Inc., 278 B.R. 189 (9th Cir. BAP 2002) (prepetition representation of creditor disclosed, but not postpetition representation or impact of creditor’s fee payment on special counsel’s fee applications); In re Molten Metal Technology, Inc., 289 B.R. 505 (Bankr. D. Mass. 2003) (failure to disclose joint defense agreement that restricted special counsel’s ability to disclose information useful to estate); In re Fretter, Inc., 219 B.R. 769 (Bankr. N.D. Ohio 1998) (inadequate disclosure by special counsel and adverse interests with respect to its representation sanctioned); but see In re Adam Furniture Industries, Inc., 191 B.R. 249 (Bankr. S.D. Ga. 1996) (lesser disclosures needed for special counsel).
\item In re Abrass, 250 B.R. 432 (Bankr. M.D. Fla. 2000); In re Tidewater Memorial Hospital, Inc., 110 B.R. 221 (Bankr. E.D. Va. 1989); In re Argus Group 1700, Inc., 199 B.R. 525 (Bankr. E.D. Pa. 1996) (bankruptcy case was two-party dispute so litigation counsel was primary legal advisor).
\item 11 U.S.C. § 327(c); In re BH & P Inc., 949 F.2d 1300 (3d Cir. 1991) explained in In re Marvel Entertainment Group, Inc., 140 F.3d 463 (3d Cir. 1998).
\item ABA Model Rule of Professional Conduct ("Model Rule") 1.7. Model Rule 1.13(e) specifically authorizes counsel for an entity to represent its officers, shareholders or other constituents also, subject to the provisions of Model Rule 1.7. But see In re Amdura Corp., 121 B.R. 862, 866 (Bankr. D. Col. 1990) (while attorney professional conduct code applies to determination of disqualification, court recognizes "that activities and multiple representation that may be acceptable in commercial settings, particularly with the informed consent of clients, may not be acceptable in bankruptcy"). See In re Covenant Financial Group of America, Inc., 243 B.R. 450 (Bankr. N.D. Ala. 1999) (no inherent conflict in
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DIP entities. However, the court may determine as a disinterested party that the client should not agree to the representation under the circumstances. Attorney ethics rules do not require disqualification for potential conflicts. Several bankruptcy courts, however, have concluded that all potential conflicts are actual conflicts.

A lawyer retained by an entity owes allegiance to the entity, and not its shareholders or partners. Counsel is not to be influenced by the personal desires of people related to the entity—sometimes a very difficult task. Majority stockholders, for example, are frequently not only officers and directors, but also guarantors of a closely-held corporation’s debts. Positions taken by the DIP can adversely affect a guarantor-controlling owner, while a contrary position could be less helpful to the corporation as a whole. The same problems occur with debtor partnerships, where a general partner is liable even without a guarantee. Partnership representing multiple entities). Advice to multiple clients includes advice on resulting attorney-client privilege limitations. In re Indiantown Realty Partners Ltd. Partnership, 270 B.R. 532 (Bankr. S.D. Fla. 2001).

15Model Rule 1.7 Comment. Some courts have written of the need for notice to creditors of DIP attorney conflicts in terms of creditor waiver. See In re Plaza Hotel Corp., 111 B.R. 882 (Bankr. E.D. Cal. 1990); In re Lee, 94 B.R. 172 (Bankr. C.D. Cal. 1988); In re BH & P, Inc., 103 B.R. 556 (Bankr. D.N.J. 1989), rev'd, in part 949 F.2d 1300 (3d Cir. 1991). See In re Perry, 194 B.R. 875 (E.D. Cal. 1996)(creditors are real parties in interest so debtor cannot waive conflict). The court in In re B.E.S. Concrete Products, Inc., 93 B.R. 228, 235 (Bankr. E.D. Cal. 1988) held that the parties themselves could waive the conflict upon appropriate disclosures, but noted that "the waiver is more difficult to obtain in a chapter 11 case because the debtor in possession stands in a fiduciary capacity that constrains its ability to make such a waiver."

16See Comment to Model Rule of Professional Conduct 1.7 ("A possible conflict does not itself preclude the representation. The critical questions are the likelihood that a conflict will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclosed courses of action that reasonably should be pursued on behalf of the client."). The Model Rules eliminated the old "appearance of impropriety" standard. In re Glenn Electric Sales Corp., 99 B.R. 596 (D.N.J. 1988).


19Id.; Model Rule 1.13(b); In re Angelika Films 57th Inc., 227 B.R. 29 (S.D.N.Y. 1998)(interests of principal placed before entity); In re Tezlaff, 31 B.R. 560 (Bankr. E.D. Wis. 1983) (court recognizes difficult to draw line between individual and closely held corporation); In re Kendavis Industries International, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988); see also In re Downtown Investment Club III, 89 B.R. 59 (Bankr. 9th Cir. 1988)(plan modification benefiting general partner at expense of other creditors established conflict in representing general partner and partnership); In re McFar, Inc., 116 B.R. 746 (Bankr. S.D. Cal. 1990) (attorney improperly took direction only from one shareholder, when other shareholder opposed to actions).


21U.P.A. § 15; In re W.F. Development Corp., 905 F.2d 883 (5th Cir. 1990)(always conflict between general and limited partner); In re Hathaway Ranch Partnership, 116 B.R. 208 (Bankr. C.D. Cal. 1990); In re Kuvkendal Place Assoc., Ltd., 112 B.R. 847 (Bankr. S.D. Tex. 1989); In re 765 Associates, 14 B.R. at 449, 450-51 (Bankr. D. Haw. 1981)(divided loyalty evidenced by partnership debtor's attorney who...
bankruptcies are likely to generate conflicts when partners, previously represented jointly, disagree on the need for filing.\textsuperscript{22}

Courts have differed in their approach to DIP counsel disqualification in affiliated entity cases. Some courts are strictly construing disinterestedness requirements of Bankruptcy Code sections 327, 328(c), and 1107(b), and disqualifying counsel based on the potential for conflicts and appearance that dual loyalty may exist.\textsuperscript{23} Others have disqualified counsel from representing related entities on evidence of actual adverse interests among them.\textsuperscript{24} Some courts have required such evidence of actual adversity before disqualifying joint counsel, deeming this a more flexible approach to economic and efficient estate administration, especially if full disclosure is made initially.\textsuperscript{25} Ethical rules authorize counsel to represent an organization and counseled partners on "claims" v. "interests"); In re McKinney Ranch Associates, 62 B.R. 249 (Bankr. C.D. Cal. 1986) (counsel disqualified from representing limited partnership debtor while representing general partners, but authorized to represent debtor after withdrawing from partner representation).


\textsuperscript{24}In re Interwest Business Equipment, Inc., 23 F.3d 311 (10th Cir. 1994); In re RKC Development Corp., 205 B.R. 869 (Bankr. S.D. Ohio 1997); In re First Ambulance Center of Tennessee, Inc., 181 B.R. 323 (Bankr. M.D. Tenn. 1995); In re Green Street, 132 B.R. 460 (Bankr. D. Utah 1991)(inter-estate claims created per se conflict); In re Chou-Chen Chemicals, Inc., 31 B.R. 842 (Bankr. W.D. Ky. 1983) (cannot represent both DIP corporation and shareholder seeking control of it); Sambo's Restaurants, 20 B.R. at 307 (DIP counsel disqualified due to representation of preferred stockholders with interests adverse to common stockholders); Roberts, 46 B.R. at 848-49 (cannot represent DIPs owing each other); In re Watson Seafood & Poultry Co., 40 B.R. 436 (Bankr. E.D.N.C. 1984); In re Baldwin-United Corp., 45 B.R. 378 (Bankr. S.D. Ohio 1983) (may not represent DIP and non-management directors in securities litigation due to potential cross-claims); see In re N.S. Garrott & Sons, 63 B.R. 189 (Bankr. E.D. Ark. 1986) (describing conflicts resulting from representing related entities, one insolvent and indebted to the other solvent debtor, in Chapter 11 cases). See also In re Freedom Solar Center, Inc., 776 F.2d 14 (1st Cir. 1985) (attorney disqualified from representing Ch. 7 debtor along with its sole shareholder and another corporation owned by the same shareholder which was purchasing the estate's assets). One court has adopted a presumption against a single law firm, trustee or creditors' committee in most related debtor cases. In re Lee, 94 B.R. 172 (Bankr. C.D. Cal. 1988).

also its constituents, such as its shareholders, when the representation of one will not adversely affect the other. According to at least one court, representation of more than one entity is “an ethical trap” where the only truly safe harbor is to represent only a single client in bankruptcy.

Concerns that joint counsel for related debtors might not vigorously pursue claims of one against the other may also be addressed through hiring special counsel to evaluate and pursue inter-estate claims, or employing an examiner to evaluate them.

C. Attorney Direction by Management.

A number of bankruptcy courts have disqualified counsel for the DIP on the grounds that the attorneys are or may be more loyal to shareholder management or partners than to the debtor entity, because they also represent that management or those partners. This reason for disqualification has been given both when the insiders are debtors in their own bankruptcy


Model Rules 1.13, 1.7. In dealing with the entity's constituents, counsel is to explain the identity of his client, the organization, when it is apparent that the interests are adverse. Model Rule 1.13(d).


In re Global Marine, Inc., 108 B.R. at 1004; In re Chicago South Shore and South Bend R.R., 101 B.R. 10 (Bankr. N.D. Ill. 1989); In re Jartran, Inc., 78 B.R. 524 (Bankr. N.D. Ill. 1987); In re Hurst Lincoln Mercury, Inc., 80 B.R. 894 (Bankr. S.D. Ohio 1987); In re O'Connor, 52 B.R. 892 (Bankr. W.D. Okla. 1985); but see In re Andura Corp., 121 B.R. 862 (Bankr. D. Colo. 1990)(relationship of firm to party adverse to debtor, and adverse party's role in the case, may be so important special counsel cannot relieve the problem). Special counsel need be disinterested only with respect to the matter on which such attorney is to be employed. 11 U.S.C. § 327(e); see In re RPC Corp., 114 B.R. 116 (M.D. N.C. 1990)(special counsel can represent DIP and former CEO and creditor of estate in lender liability action where interests are identical).
cases,\textsuperscript{29} and when the insiders have not filed.\textsuperscript{30} Some courts address disqualification on this ground case by case, expressly deciding without a \textit{per se} rule.\textsuperscript{31}

Although insider management may have its own agenda, counsel for an entity must nonetheless take her direction from that very management. Counsel should not be disqualified for doing what is ethically required; if management breaches fiduciary duties it should be ordered replaced, and counsel should be sanctioned only to the extent of any Rule 9011 violation. When counsel furthers management violations of fiduciary duties and self dealing efforts, fee sanctions are likely, however.\textsuperscript{32}

\textsuperscript{29}In re Occidental Financial Group, Inc., 40 F.3d 1059 (9th Cir. 1994); In re W.F. Development Corp., 905 F.2d 883 (5th Cir. 1990)(cannot represent limited and general partners in bankruptcy); In re Westwood Homes, Inc., 157 B.R. 182 (Bankr. D. Me. 1993); In re Churchfield Management & Investment Corp., 100 B.R. 389 (Bankr. N.D. Ill. 1989)(insider was power behind the debtor, although not named as an officer or director; In re Parkway Calabasas, 89 B.R. 832 (Bankr. C.D. Cal. 1988); In re Lee, 94 B.R. 172 (Bankr. C.D. Cal. 1988); In re Al Gelato Continental Desserts, Inc., 99 B.R. 404 (Bankr. N.D. Ill. 1989).


\textsuperscript{33}
Connections by other DIP professionals to management and insiders may likewise be disqualifying and adversely affect reorganization efforts.\textsuperscript{33}

D. Fee-Related Disqualification.

Payment of fees by third parties is expressly sanctioned by the Model Rules of Professional Conduct, as long as client consent is obtained, client confidentiality protected, and no interference is imposed on the lawyer’s independent professional judgment or lawyer-client relationship.\textsuperscript{34} Payment to a lawyer by a third party is not uncommon, with payments frequently being made by insurance carriers, prepaid legal plans, employers and parents.\textsuperscript{35}

Several courts have recognized that fee payment from sources other than the debtor may subject counsel to the temptation of furthering the payor’s interests and deviating from the duty of undivided loyalty to the real client.\textsuperscript{36}

Some courts have allowed the DIP’s partners or shareholders to protect their investment by individually paying or guaranteeing the DIP’s attorneys’ fees,\textsuperscript{37} even if the related entity is also a creditor.\textsuperscript{38} But one court has stricken such guarantees from fee agreements.\textsuperscript{39} Other courts have terminated counsel’s representation because of the appearance of conflict and potential for conflict when the motives of the retainer payor are suspect in light of creditor status and other entanglements with the estate.\textsuperscript{40} Some courts flatly held that any fee payment by a

\textsuperscript{33}In re Condor Systems, Inc. 302 B.R. 35 (Bankr. N.D. Cal. 2003); In re Coram Healthcare Corp., 271 B.R. 228 (Bankr. D. Del. 2001) (DIP’s CEO connections to largest creditors board member and served its interest).

\textsuperscript{34}Model Rule of Professional Conduct 1.8(f); comment to Model Rule 1.7.

\textsuperscript{35}See In re Bohl Risidorante, Inc., 99 B.R. 971 (9th Cir. BAP 1989)(gift from ex-wife).


\textsuperscript{40}In re Rabex Amaru of North Carolina, Inc., 198 B.R. 892 (Bankr. M.D.N.C. 1996); In re Crivello, 194 B.R. 463 (Bankr. E.D. Wis. 1996); In re Adam Furniture Industries, Inc., 158 B.R. 291 (Bankr. S.D. Ga. 1993)(fees received from entities subject to avoidance and recovery actions by the estate); In re Black Hills
third party is an actual conflict of interest disqualifying a professional from employment “absent a showing that the interests of the third party and the bankruptcy estate are identical” upon notice to all parties. 

Disqualification due to third party fee payments or guaranties reduces the likelihood that competent counsel can be retained in some Chapter 11 cases. The estate may be fully liened; Section 506(c) collateral surcharges may be limited by the court; counsel risks her initial case evaluation proving overly optimistic, but not being allowed to withdraw.

A security interest on the estate’s unencumbered or under-encumbered assets to help assure fee payment may be allowed by some courts, after a thorough review of all the circumstances by the court.

A retainer may result in a disqualifying conflict of interest if it is obtained without authorization from a secured lender’s cash collateral. A fee agreement providing that counsel


In re Flagstaff Food Service Corp., 739 F.2d 73 (2d Cir. 1984); In re Grant Associates, 154 B.R. 836 (S.D.N.Y. 1993)(DIP counsel entitled to surcharge rental income cash collateral only to extent creditor benefited); see extensive citations in In re CD Electric Co., 146 B.R. 786 (Bankr. N.D. Ind. 1992).


In re Martin, 817 F.2d 175 (1st Cir. 1987)(not per se invalid; numerous factors listed for court review); see In re Printcrafters, Inc., 208 B.R. 968 (Bankr. D. Colo. 1997)(security interest in retainer precludes disinterestedness); In re City Mattress, Inc., 163 B.R. 687 (Bankr. W.D.N.Y. 1994); In re Quincy Air Cargo, Inc., 155 B.R. 193 (C.D. Ill. 1993)(security interest in vehicles permissible); In re Gilmore, 127 B.R. 406 (Bankr. M.D. Tenn. 1991)(bond in lieu of retainer given without creditor objection and with attorney agreement not to invoke bond absent court permission); In re Carter, 116 B.R. 123 (E.D. Wisc. 1990)(attorney could secure bankruptcy-related fees with assignment of land contract vendor's interest in debtor's real estate, although he became a creditor upon perfection of the security interest); but see In re Pierce, 809 F.2d 1356 (8th Cir. 1987) (attorneys' prepetition mortgage on estate assets disqualifying); In re Escalera, 171 B.R. 107 (Bankr. E.D. Va. 1994)(same, refusing to follow Martin); In re Automend, Inc., 85 B.R. 173 (Bankr. N.D. Ga. 1988)(security interest in accounts receivable disallowed, due to increased likelihood of potential conflict becoming actual and appearance of overreaching); In re Whitman, 51 B.R. 502 (Bankr. D. Mass. 1985)(fee disgorgement required where fees paid upon sale of asset subject to undisclosed attorney lien). Counsel should comply with Model Rule 1.8 in documenting any such transaction. A prepetition secured claim for fees unrelated to the current bankruptcy case is disqualifying.

In re CIC Investment Corp., 175 B.R. 52 (9th Cir. BAP 1994). See also In re Mahendra, 131 F.3d 750 (8th Cir. 1997)(prepetition security interest in property ceased upon bankruptcy under state law; lien for prepetition fees earned is disqualifying adverse interest).
may dismiss or convert the case if money is not regularly escrowed for fees causes a disqualifying potential adverse interest between lawyer and client.46

Although some courts assert authority over any payment counsel receives from any source pursuant to Section 329,47 the Fifth Circuit has ruled that the bankruptcy court had no right to require disgorgement by DIP counsel of non-estate funds, even if paid by the debtor, for services unrelated to the bankruptcy case.48 And pre-bankruptcy payment for non-bankruptcy work is not subject to disgorgement, as long as there is no preference.49 While bankruptcy fee payment by a third party guarantor must be disclosed and the guaranty arrangement approved, some courts have held that fee applications need not be filed before the guarantor pays;50 others require such applications.51 An agreement by creditors to pay bonuses based on an examiner’s results must be disclosed, and may render the examiner no longer disinterested.52 A success fee for assistance to certain creditors may be held payable from those creditors’ recovery alone.53

Courts are divided on disqualifying DIP counsel due to non-bankruptcy related unpaid prepetition fees. Most – including all circuit courts – strictly construe Section 327(a) to mandate disqualification as a creditor.54 A number of cases disqualifying on grounds of such

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45 In re Smitty's Truck Stop, Inc., 210 B.R. 844 (10th Cir. BAP 1997).
47 In re Downs, 103 F.3d 472 (6th Cir. 1996) (retainer from third party to be held in trust in which estate has interest); In re Land, 138 B.R. 66 (D. Neb. 1992), aff'd. without opinion, 994 F.2d 843 (8th Cir. 1993), reported in full, 1993 U.S. App. LEXIS 11348 (8th Cir. 1993); In re Land, 116 B.R. 798 (D. Colo. 1990), aff'd, remanded, 943 F.2d 1265 (10th Cir. 1991); In re Hathaway Ranch Partnership, 116 B.R. 208 (Bankr. C.D. Cal. 1990); In re Boh! Ristorante, Inc., 99 B.R. 971 (9th Cir. BAP 1989); Senior G & A Operating, 97 B.R. 307 (Bankr. W.D. La. 1989); In re Furniture Corp., 34 B.R. 46 (Bankr. S.D. Fla. 1983).
48 Matter of Hargis, 887 F.2d 77 (5th Cir. 1989), modified on rehearing, 895 F.2d 1025 (5th Cir. 1990);
50 David & Hagner, P.C. v. DHP, Inc., 171 B.R. 429 (D.D.C. 1994) aff'd 70 F.3d 637 (D.C. Cir. 1995); see In re Engel, 124 F.3d 567 (3d Cir. 1997)(DIP must obtain court approval to retain any attorney, even criminal, regardless of source of compensation); In re W.T. Mayfield Sons Trucking Co., Inc., 225 B.R. 818 (Bankr. N.D. Ga. 1998); but see In re Independent Engineering Co., Inc., 232 B.R. 529 (1st Cir. BAP 1999)(must disclose draws against retainer from non-debtor); see In re Metropolitan Environmental, Inc., 293 B.R. 871 (Bankr. N.D. Ohio 2003) (disclose guaranty even if contingencies to draw on the guaranty have not arisen).
51 In re Independent Engineering Co., Inc., 197 F.3d 13 (1st Cir. 1999).
53 In re Farmland Industries, Inc., 296 B.R. 188 (8th Cir. BAP 2003).
creditor status involve failure to disclose the creditor status initially and additional conflicts.\textsuperscript{55} A few courts have concluded that the Section 1107(b) exemption from the disinterestedness requirement of Section 327(a) includes an exemption for any professional who is a creditor solely because of prepetition employment on behalf of the DIP.\textsuperscript{56} Or they have allowed creditor professionals to serve the DIP as a matter of discretion based on the needs of the case, but those cases did not withstand appellate security.\textsuperscript{57}

Prepetition receipt of fees subject to avoidance as a preference creates a disqualifying conflict of interest.\textsuperscript{58} A firm may be held not disinterested if fees paid to an individual member as a receiver or trustee in fact belong to the firm.\textsuperscript{59}

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\textbf{E. DIP’s Counsel’s Representation of the Estate’s Creditors.}
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A professional is not disqualified as DIP counsel solely because of employment by a creditor under the Bankruptcy Code, absent objection by another creditor or the U. S. Trustee, whereupon the court is to disapprove the employment if an actual conflict of interest exists.\textsuperscript{60} That section of the Bankruptcy Code was amended in 1984. Prior to the amendment, it stated that the professional could not, while representing the trustee [or DIP] represent a creditor in connection with the case. The option to represent both now appears open in the absence of an actual conflict, e.g. in the case of an anticipated plan paying creditors in full, a fully secured creditor with collateral the debtor plans to give up, or an insider creditor willing to accept

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\item \textsuperscript{60}In re Sabre Int'l., Inc, 289 B.R. 420 (Bankr. N.D. Okla. 2003).
\item \textsuperscript{61}U.S.C. § 327(c); In re Zenith Electronics Corp., 241 B.R. 92 (Bankr. D. Del. 1999)(prior representation of creditor/shareholder against debtor is actual conflict, and cannot be waived (by equity committee) when objection is made).
\end{enumerate}
\end{footnotesize}
subordinated treatment. If a former client creditor objects and the matters are substantially related, the bankruptcy court may enforce ethical code prohibitions on representation. Creditors’ counsel often has been allowed to represent the estate as special counsel to pursue matters where the estate and creditor have a common interest.

Even under the present, more liberal version of Section 327(c), courts have not allowed counsel to actively represent a creditor in the same bankruptcy case in which the trustee or DIP is represented, at least without full disclosure and an opportunity to object. And even where DIP counsel is not representing the creditor in connection with the bankruptcy case, allegiance to a creditor client may be considered to preclude counsel from investigating preferences, fraudulent conveyances, and so forth adequately, and to inhibit effective negotiation of a reorganization plan.

65 In re Cook, 223 B.R. 782 (10th Cir. BAP 1998)(contingency fee agreement with creditor increased risk of alignment with creditor interest adverse to trustee he also represented and incentive to shift assets among related estates); In re Granite Partners, L.P., 219 B.R. 22 (Bankr. S.D.N.Y. 1998); In re Envirodyne Industries, Inc., 150 B.R. 1008 (Bankr. N.D. Ill. 1993); In re American Printers & Lithographers, Inc., 148 B.R. 862 (Bankr. N.D. Ill. 1992); In re Amdura, 121 B.R. 862 (Bankr. D. Colo. 1990) and 139 B.R. 963 (Bankr. D. Colo. 1992)(creditor may play such a key role in the case, and represent such an important part of the law firm's fees, that even having separate counsel for the creditor in the bankruptcy case would be an inadequate solution to the conflict); Matter of Status Game Corp., 102 B.R. 19 (Bankr. D. Conn. 1989) (law firm that represented undersecured creditor holding substantial claim was disqualified as counsel for debtor, even though representation of creditor was on matters unrelated to case); but see In re Marvel Entertainment Group, Inc., 140 F.3d 463 (3d Cir. 1998)(representation on minor, unrelated matter not disqualifying); In re Dynamark, Ltd., 137 B.R. 380 (Bankr. S.D. Cal. 1992)(DIP counsel's firm vigorously represented DIP while representing major secured creditor on unrelated matters); see In re W.T. Grant Co., 699 F.2d 599, 613 (2d Cir. 1983)(5 days of representing creditors de minimus, and does not require disqualification of trustee's counsel); In re Fondiller, 15 B.R. 890, 892 (9th Cir. BAP 1981) (pre-1984 version of § 327(c), court finds...
Model Rule of Professional Conduct 1.7 provides that a lawyer shall not represent a client if the representation will be directly adverse to another client or materially limited by the lawyer’s responsibilities to another client unless (1) the lawyer reasonably believes the representation will not adversely affect the relationship and (2) each client consents after consultation, which shall include an explanation of the implications of common representation and the advantages and risks involved.66

Model Rule of Professional Conduct 2.2 provides that a lawyer may act as an intermediary between clients if (1) he consults with each about the implications of common representation, including the advantages and risks, and effect on attorney-client privileges, and obtains each client’s consent; (2) the lawyer reasonably believes the matter can be resolved on terms compatible with the clients’ best interests, each will be able to make adequately informed decisions, and there is little risk of material prejudice if the contemplated resolution is unsuccessful; and (3) the lawyer reasonably believes the common representation can be undertaken impartially and without improper effect on the responsibilities the lawyer has to the clients. The lawyer is to consult with each client throughout the representation to enable their adequately informed decisions, and is to withdraw if any of the clients requests or if any of the conditions warranting ethical joint representation is no longer satisfied. At that point the lawyer may not continue to represent any of the clients.

F. Attorney’s Ownership Interest in the DIP and Serving as Officer or Director.

An “insider” and an “equity security holder” are not “disinterested.” 67 An “insider” includes a general partner of the debtor, and a director or officer of a debtor corporation.68 Some courts have allowed counsel or other professionals to represent the DIP despite a small number of shares of the publicly traded debtor being held by a firm member.69 But other courts

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66One county bar ethics committee has opined that an attorney can never ethically represent a debtor when one of that debtor's creditors is a firm client, even when the attorney has not and will not represent the creditor in connection with that debt. Suffolk, New York Bar Ethics Opinion 91-1. The Arizona Supreme Court has ruled that Code § 327(c) does not release an attorney from state law ethical requirements, and sanctioned an attorney for, inter alia, filing a bankruptcy case for one client adverse to a former client creditor, Matter of Breen, 171 Ariz. 250, 830 P.2d 462 (1992), and held that a creditor client's consent to representation of a debtor client must be freely given, without pressure by the attorney. Matter of Neville, 147 Ariz. 106, 708 P.2d 1297 (1985). But see In re Peck, 112 B.R. 485 (Bankr. D.Conn. 1990) (court refused to disqualify DIP counsel due to prior representation of a creditor in connection with documenting a loan to the debtor, where the integrity and validity of the loan documents were not being challenged, although a preference claim might be asserted for payments on the loan).


69 Matter of Federated Department Stores, Inc., 20 B.C.D. 973 (Bankr. S.D. Ohio 1989)(investment banker owned $104,000 debt securities and 20,343 equity securities, deemed minimal in light of its $16.3 billion securities portfolio; per internal policies, banker precluded from continuing to buy or sell debtor's securities for its own account); In re O'Connor, 52 B.R. 892 (Bankr. W.D. Okla. 1985) (firm members owned less than 1,000 shares of 12,969,626 outstanding DIP stock). See also In re Microdisk, Inc., 33 B.R. 817 (D. Nev. 1983)(court allowed trustee to continue serving despite litigation over alleged ownership of
have been much more strict, requiring disqualification despite firm attorneys’ ownership of only a small percentage of the outstanding equity shares of the DIP, and despite firm members holding only the office of secretary to facilitate documentation of transactions. Most cases disqualifying counsel on these grounds involve larger equity roles in privately held debtors and service on the board directly and indirectly controlling the company. Counsel’s actions during the case, including running for office and placing people on the board of directors, may make him into an insider.

G. Effectiveness of Curative Measures.

Bankruptcy courts have often imputed disqualification of a single attorney in a firm to the entire firm, applying the imputed knowledge principle of professional responsibility rules, generally without analysis. Recent well-reasoned decisions, however, conclude that disqualification should not be imputed to the entire firm if a lawyer is deemed not disinterested for non-conflict reasons, such as prior service as a director or officer of the debtor.
of a lawyer who advised a former client creditor through implementation of an “Ethical Wall” may also suffice to waive any conflict disqualification. However, the Delaware Bankruptcy Court has refused to allow such creative measures, in part because in light of the current climate of distrusting officers and directors, it is entirely possible that all officers of the debtor may be at least interrogated, and the firm would be placed in an untenable position of deciding to question one of the partners.

Several courts have allowed counsel to overcome disinterestedness concerns and represent a DIP if curative measures are taken to resolve non-disinterestedness status after full disclosure, such as such as sale of shares in the DIP company or resignation from the board of directors or an officer of the company and recusal from board deliberations, ceasing to represent an affiliated party, or returning possibly preferential fee payments. Appointment of special counsel to deal with conflict-related claims may suffice. Other courts have such actions unavailing.

In several instances, courts have also allowed counsel to represent the DIP despite status as a creditor, if the attorney waives the claim. Again, other courts refuse to sanction such
proposals, and a few courts have allowed counsel to represent the DIP without requiring any corrective action.

Some courts have also allowed counsel to represent the DIP despite failure initially to seek court approval for the appointment, *nunc pro tunc.* Others have flatly disallowed fees for services performed prior to or without a court appointment order. Fees cannot be awarded on a *quantum meruit* basis or substantial contribution basis unless court approval of employment is obtained, initially or *nunc pro tunc* where such retroactive relief is available.

**H. Disclosure is Mandatory.**

Bankruptcy Rule 2014 requires disclosure of “any proposed arrangements 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 rule is much more comprehensive than the applicable statutes, 11 U.S.C. §§ 327 and 1103.

“Connections” has been broadly construed. Courts have cautioned that it is not for the DIP or its counsel to determine unilaterally whether a connection is relevant; the court is to review all connections and decide whether there are any disqualifying conflicts.

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85 E.g., In re THC Financial Corp., 837 F.2d 389 (9th Cir. 1988); Matter of Triangle Chemicals, 697 F.2d 1280 (5th Cir. 1983); In re Land, 943 F.2d 1265 (10th Cir. 1991); In re Arkansas Co., 798 F.2d 645 (3d Cir. 1986); F/S Airlease II, Inc. v. Sunon, 844 F.2d 99 (3d Cir.) cert. denied, 109 S.Ct. 137 (1988); In re Mehdiipour, 202 B.R. 474 (9th Cir. BAP 1996).
86 In re Keren Ltd. P’ship, 189 F.3d 86 (2d Cir. 1999); In re Simpson, 41 F3d 316 (7th Cir. 1994); In re Occidental Financial Group, Inc., 40 F.3d 1059 (9th Cir. 1994); In re Land, 943 F.2d 126 (10th Cir. 1991); In re Weibel, 176 B.R. 209 (9th Cir. BAP 1994); In re Kroeger Properties and Development, Inc., 57 B.R. 821 (9th Cir. BAP 1986); In re Tidewater Memorial Hospital, Inc., 110 B.R. 221 (Bankr. E.D. Va. 1989); In re Peoples Savings Corp., 114 B.R. 151 (Bankr. N.D. Ill. 1990); In re Met-L-Wood Corp., 103 B.R. 972 (Bankr. N.D. Ill. 1989); In re Hargis, 73 B.R. 622 (Bankr. N.D. Tex. 1987), rev’d on other grounds, 887 F.2d 77 (5th Cir. 1989); In re McKinney Ranch Associates, 62 B.R. 249 (Bankr. C.D. Cal. 1986); In re Nashville Union Stockyard Restaurant, 54 B.R. 391 (Bankr. M.D. Tenn. 1985); In re Lewis, 30 B.R. 404 (Bankr. E.D. Pa. 1983); In re Byman Furniture & Interiors, Inc., 14 B.R. 230 (Bankr. S.D. Tex. 1981); see also In re Marshall, 211 B.R. 662 (Bankr. D. Minn. 1997) (if court denies attorney’s employment application, services rendered are strictly gratuitous).
87 In re Milwaukee Engraving Co., Inc., 219 F.3d 635 (7th Cir. 2000); In re Keren Ltd. P’ship, 189 F.3d 86 (2d Cir. 1999); In re Occidental Financial Group, Inc., 40 F.3d 1059 (9th Cir. 1994); In re Weibel, 176 B.R. 209 (9th Cir. BAP 1994). See See In re Bolton-Emerson, Inc., 200 B.R. 725 (D. Mass. 1996)(valid § 327 appointment order is condition precedent to compensation); In re Famous Restaurants, Inc., 205 B.R. 922 (Bankr. D. Ariz. 1996) (§ 327 appointment order required for § 506(c) surcharge).
89 See, e.g., In re Hot Tin Roof, Inc., 205 B.R. 1000 (1st Cir. BAP 1997); In re Condor Systems, Inc., 302 B.R. 55 (Bankr. N.D. Cal. 2003) (separate business venture negotiations with debtors shareholders is a connection that must be disclosed); In re C&C Demo, Inc., 273 B.R. 502 (Bankr. E.D. Tex. 2001)(and cases
Some courts have said that even the most trivial and attenuated and outdated connections must be disclosed.\(^91\) But despite the broad directives, the actual connections on which courts have focused in cases sanctioning professionals for nondisclosure of connections (even without damage to the estate) have been within the legitimate scope of inquiry under the applicable statutory standard. At least one court expressly recognized that connections which are meaningless under the statutory tests for employment approval need not be disclosed. In *Rusty Jones*,\(^92\) the court noted it was not necessary for the debtor’s counsel to disclose he had owned a hot dog stand 20 years before with one of the debtor’s indirect owners, because that connection was remote, *de minimus* and irrelevant to a § 327 analysis.

What is important are connections that presently exist or recently existed between the attorney and the parties in interest, and also past connections of business or personal nature that are either related to the bankruptcy proceedings or could reasonably have an effect on the attorney’s judgment in the case.\(^93\)

*Id.* The same principle was indirectly recognized by the Second Circuit in *Arlan’s Dep’t. Stores*.\(^94\) DIP counsel argued in *Arlan’s* that the predecessor to Rule 2014 required “disclosure only of present ‘connections’ that are ‘adverse to the debtor’” and that “every large New York firm has had prior relations with almost every other large New York firm, and to require the specification of all of these past associations would engulf the court in trivia.”\(^95\) The court responded that the undisclosed fee sharing agreement at issue in the case was a connection that was “hardly trivia,” and indeed could reasonably be construed as “trafficking in bankruptcy appointments,” implicitly acknowledging that normal professional and social relationships among professionals do not warrant disclosure.

The bottom line is that the court may assume misplaced loyalties and other dire results of direct and indirect connections, and assume the worst motives and results of potential


\(^{91}\) *In re Begun*, 162 B.R. 168, 177 (Bankr. N.D. Ill. 1993), citing *In re Enviroydne Industries, Inc.*, 150 B.R. 1008, 1021 (Bankr. N.D. Ill. 1993); *In re Crivello*, 194 B.R. 463, 466 (Bankr. E.D. Wis. 1996)(applicants do not have unilateral right to withhold information “regardless of how attenuated the connection may be”); *In re EWC*, 138 B.R. 276, 281 (Bankr. W.D. Okla. 1992)(“The professional cannot pick and choose which connections to disclose. No matter how old the connection, no matter how trivial it appears, the professional seeking employment must disclose it”).


\(^{93}\) *Id.*, 134 B.R. at 346.

\(^{94}\) *Matter of Arlan’s Department Stores*, 615 F.2d 925, 932 (2d Cir. 1979).

\(^{95}\) *Id.*, 615 F.2d at 932.
litigation. It may assume potential conflicts will become actual conflicts. The test for disclosure is not whether counsel believes the connection to be de minimus; the test is whether the connection is relevant to the statutory standards, should the court conclude it is significant instead of trivial. As the court put it in Rusty Jones, it is not enough that the attorneys did not feel a conflict existed; “it should have been apparent from …the connections…that conflicts of interest would at least be an issue.” In Hathaway Ranch Partnership, the court phrased it as “all facts that may be pertinent to a court’s determination of whether an attorney is disinterested or holds an adverse interest to the estate.”

Once the relevancy threshold for disclosure of even de minimus connections is met, sufficient information needs to be disclosed to enable the court to judge whether the connection is disqualifying. The disclosures have to be sufficiently detailed to enable the court to understand the magnitude of the connections and potential conflicts, and must be strictly accurate.

An employment application with full disclosure must be made for each professional firm employed; undisclosed subcontracting is impermissible. Disclosure through the schedules...


Attorneys representing DIPs prepare pleadings for their client’s signature, including applications for their own employment. They are obliged to inquire into and analyze the factual and legal elements of every document signed and filed.\footnote{Bankruptcy Rule 9011; In re Pierce, 809 F.2d 1356 (8th Cir. 1987)(applying Rule 9011 to erroneous application to employ counsel); In re Jacobsen, 47 B.R. 476 (D. Colo. 1985); In re Dreiling, 233 B.R. 848, 870 (Bankr. D. Colo. 1999)(fundamental premise of our judicial system is that attorneys are officers of the court; when they address a judge it is virtually made under oath); Model Rule 3.1 and comment.} A half-hearted inquiry into conflicts among firm members is inadequate. It is counsel’s responsibility to ensure complete disclosure.\footnote{In re Thrifty Oil Co., 205 B.R. 1009 (Bankr. S.D. Cal. 1997)(accounting firm's conflict check inadequate); In re Perry, 194 B.R. 875 (E.D. Cal. 1996)(trustee's attorney failed to conflict check purchaser of estate assets -- represented by own firm); In re Michigan General Corp., 78 B.R. 479, 482 (Bankr. N.D. Tex. 1987)("Unfortunately, the burdens of the Bankruptcy Code are not met by a white heart. Negligence does not excuse the failure to disclose a possible conflict of interests."); In re Kelton Motors, Inc., 109 B.R. 641, 649 (Bankr. D. Vt. 1989)("attorney's ethical duty to inform the Court of the existence of possible ethical violations").} Special counsel cannot simply rely on the DIP’s primary bankruptcy counsel to handle necessary filings.\footnote{In re Hart-Albin Co., 164 B.R. 331 (Bankr. D. Mont. 1992); In re Crook, 79 B.R. 475 (9th Cir. B.A.P. 1987). On the other hand, general bankruptcy counsel has been sanctioned for failure to disclose lack of disinterestedness of estate professionals. Matter of CF Holding Corp., 164 B.R. 799 (Bankr. D. Conn. 1994). See In re Adam Furniture Industries, Inc., 191 B.R. 249 (Bankr. S.D. Ga. 1996)(lesser disclosures needed for special counsel); but see In re Maximus Computers, Inc., 278 B.R. 189 (9th Cir. BAP 2002)(inadequate disclosures by special counsel); In re Fretter, Inc., 219 B.R. 769 (Bankr. N.D. Ohio 1998)(full disclosure of facts bearing on special counsel’s adverse interests).}
Full disclosure of all aspects of fee arrangements is also required. Complete disclosure of prepetition payments “in connection with” and “in contemplation of” bankruptcy must be disclosed, in addition to disclosure of retainer arrangements.

I. Sanctions for Conflicts and Failure to Disclose Potential Bases for Disqualification.

The most common consequence of non-disinterestedness is termination of the representation, with fee denial or disgorgement of interim payments, but suspension from practice, disbarment, and even criminal convictions have been imposed for blatant non-disclosure violations. The court may disqualify counsel from representing the DIP based upon an objective standard, evaluating the facts of each case, regardless of the integrity or intent of the attorney.

The Bankruptcy Code specifically authorizes—but does not require—courts to deny fees and reimbursement of expenses if at any time during the employment, the attorney is not disinterested or holds or represents an interest adverse to the estate with respect to the matter for which the attorney is employed. If the attorney was never appointed as counsel, and is not disinterested or otherwise not entitled to nunc pro tunc employment, the court cannot award fees on grounds of quantum meruit, a substantial contribution to the case, or other equitable

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105 In re Big Rivers Electric Corp., 2004 WL 34848 (6th Cir. 2004); In re Kisseberth, 273 F.3d 714 (6th Cir. 2001); In re Lewis, 113 F.3d 1040 (9th Cir. 1997); In re Downs, 103 F.3d 472 (6th Cir. 1996) (disgorgement of all fees mandatory); In re Park-Helena Corp., 63 F.3d 877 (9th Cir. 1995) cert. denied, 116 S. Ct. 712 (1996) (strict compliance); In re Pierce, 809 F.2d 1356 (8th Cir. 1987); In re Arlans Departments Stores, Inc., 615 F.2d 925 (2d Cir. 1979); In re Solfanelli, 230 B.R. 54 (M.D. Pa. 1999) (disclose retainer given after court approval of retention and source of pre-approval retainer); In re Independent Engineering Co., Inc., 232 B.R. 529 (1st Cir. BAP 1999) (disclose draws against retainer supplied by non-debtor and nature of fee agreement); In re Metropolitan Environmental, Inc., 293 B.R. 817 (Bankr. N.D. Ohio 2003) (disclose guaranty even though payment contingencies have not arisen); In re Smitty's Truck Stop, Inc., 210 B.R. 844 (10th Cir. BAP 1997); In re Florence Tanners, Inc., 209 B.R. 439 and 213 B.R. 129 (Bankr. E.D. Mich. 1997), aff'd in relevant part Halbert v. Yousif, 225 B.R. 336 (E.D. Mich. 1998).


109 11 U.S.C. § 328(c); Gray v. English, 30 F.3d 1319 (10th Cir. 1994).
grounds. If the attorney was approved as counsel, and later found disqualified, courts are divided on their discretion to award or not award fees.

In many reported cases, the courts appear to have denied payment of all fees to attorneys who did not meet disinterestedness requirements. In so holding, several courts emphasized that the attorney failed to disclose grounds for disqualification. Fee disallowance was imposed even when, in retrospect, no harm has been shown from the facts that should have

\[10^\text{In re Albrecht, 233 F.3d 1258 (10th Cir. 2000); In re Milwaukee Engraving Co., 219 F.3d 635 (7th Cir. 2000) reversing 230 B.R. 370 (Bankr. E.D. Wis. 1998) and overruling In re Milwaukee Boiler Mfg. Co., 232 B.R. 122 (Bankr. E.D. Wis. 1999)(compensation for emergency services while employment application pending and before disallowance); In re Occidental Financial Group, Inc., 40 F.3d 1059 (9th Cir. 1994); In re Grabill Corp., 983 F.2d 773 (7th Cir. 1993); In re Monument Auto Detail, Inc., 9th Cir. BAP 1998); In re Weibel, Inc., 176 B.R. 209 (9th Cir. BAP 1994); In re Anicom, Inc., 273 B.R. 756 (Bankr. N.D. Ill. 2002); In re Stoico Restaurant Group, Inc., 271 B.R. 655 (Bankr. D. Kan. 2002); In re Encapsulation Intern., LLC, 226 B.R. 614 (Bankr. W.D. Tenn. 1998).}\n
\[11\text{In re Crivello, 134 F.3d 831 (7th Cir. 1998)(discretion); In re Federated Dept. Stores, Inc., 44 F.3d 1310 (6th Cir. 1995)(permitted under "peculiar and unique" circumstances); In re CIC Inv. Corp., 192 B.R. 549 (9th Cir. BAP 1996)(permitted); contra In re BBQ Resources, Inc., 237 B.R. 639 (Bankr. E.D. Ky. 1999)(no discretion to pay fees if initial employment order set aside on motion for reconsideration).}\n
been disclosed.\textsuperscript{114} Other courts have not required total disgorgement when the need for attorney discipline is outweighed by the equities of the case.\textsuperscript{115} One court, explicitly exercising its discretion and flexibility to correct a situation, denied payment of additional fees until a plan providing for payment of 100\% of all creditors’ claims was confirmed and implemented, to avoid speculation as to actual harm caused by conflicting interests.\textsuperscript{116} Another accomplished a similar result by subordinating fees to unsecured creditors’ claims.\textsuperscript{117} Intentional nondisclosure may be treated as a fraud on the court, warranting denial of all compensation as a severe sanction, and ignoring other factors applicable in cases where concealment is not intentional.\textsuperscript{118} Nondisclosure harming the estate may be sanctioned without the court also finding a conflict of interest.\textsuperscript{119}


\textsuperscript{116} In re Guy Apple Masonry Contractor, Inc., 45 B.R. 160 (Bankr. D. Ariz. 1984); see also In re Jartran, Inc., 78 B.R. 524 (Bankr. N.D. Ill. 1987)(court appointed examiner to evaluate alleged conflicting relationship, DIP claims against creditor represented by DIP counsel, and status of consensual plan alleged to obviate conflict issue, then delayed appointment pending plan negotiations).


The court may order fee disgorgement to the estate even if the fees were originally paid by third parties.\textsuperscript{120} Courts have also required disgorgement of fees received from the estate without prior court disclosure, and reduced fees for nondisclosure of all compensation arrangements.\textsuperscript{121}

DIP clients suffer repercussions from disqualification after the case is underway, as well. Withdrawal may require duplicative catch-up time of new counsel that a company in distress may not easily afford.\textsuperscript{122} The DIP may also suffer from the court’s vacating of critical orders obtained by disqualified counsel.\textsuperscript{123}

An evidentiary hearing is not required before a court requires disgorgement of fees on grounds of disqualification.\textsuperscript{124} Courts are divided on whether a decision to appoint or disqualify


\textsuperscript{123} Matter of Cropper Co., Inc., 35 B.R. 625, 630 (Bankr. M.D. Ga. 1983)(order authorizing use of cash collateral set aside; DIP should not be allowed to use cash collateral without counsel to advise it).

\textsuperscript{124}In re Land, 943 F.2d 1265 (10th Cir. 1991); In re Placid Oil Co., 158 B.R. 404 (N.D. Tex. 1993). There is inherent notice on a bankruptcy fee application that the ethical conduct of the attorney seeking fees is up for consideration. See In re Devers, 33 B.R. 793 (D.D.C. 1983), appeal dismissed, 729 F.2d 863 (D.C. Cir. 1984); In re Diamond Mortgage Corp. of Illinois, 135 B.R. 78 (Bankr. N.D. Ill. 1990); In re Kendavis
counsel or sanction counsel’s disqualification through reduced or disgorged fees on an interim basis is an interlocutory, non-appealable order.\(^{125}\)

\[\text{J. Conclusive Effect of Fee Award, and Indemnity, for Ethical Violations.}\]

When a reorganization case fails, the Chapter 7 trustee and creditor body may seek to find the professionals at fault. In the *Merry-Go-Round* case, a malpractice suit against the restructuring accountants and business advisors was remanded from bankruptcy court to state court, then settled for $185 million.\(^{126}\)

Objections to the quality of services provided, and their benefit to the bankruptcy estate, are considered by the court when awarding fees to a professional employed by the estate.\(^{127}\) If such objections are raised, or if they could have been raised, a fee award or disgorgement order thereafter has been held to bar later malpractice claims under the doctrine of *res judicata*.\(^{128}\)

If a professional deliberately conceals evidence of ethical violations, the professional may nonetheless be charged with a claim of fraud on the court, despite an apparent release in a court order.\(^{129}\) A judgment may be set aside under Rule 60(b) at any time for fraud on the court.\(^{130}\) One court held it could set aside an order approving counsel’s employment and order disgorgement of fees awarded. It also held that the Chapter 7 trustee stated a claim for fraud on the court when the DIP’s counsel avowed no prior connections with the debtor and no adverse interest, when in fact it had represented the debtor’s general partners prepetition in setting up limited partnerships into which the debtor’s assets were transferred.\(^{131}\)

Some DIP professionals have sought to include indemnity provisions in their engagement agreements, and to limit any damage claims to disgorgement of fees received.

\[\text{Industries International, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988); but see \textsection VIII B. A decision to appoint or disqualify counsel or sanction counsel's disqualification through reduced or disgorged fees on an interim basis has been held to be an interlocutory, non-appealable order. In re Firstmark Corp., 46 F.3d 653 (7th Cir. 1995})(and cases cited therein).}\]

\[\text{Compare In re Arochem Corp., 176 F.3d 610 (6th Cir. 1999)(final); In re BH&P, Inc., 949 F.2d 1300 (3d Cir. 1991)(same); In re A.H. Robins Co., 828 F.2d 239 (4th Cir. 1987)(same) with In re Firstmark Corp., 46 F.3d 653 (7th Cir. 1995) (not final); In re Devlieg, Inc., 56 F.3d 32 (7th Cir. 1995)(same); In re Westwood Shake & Shingle, Inc., 971 F.2d 387 (9th Cir. 1992)(same); In re Delta Servs. Indus., 782 F.2d 1267 (5th Cir. 1986)(same); In re Continental Inv. Corp., 637 F.2d 1 (1st Cir. 1980)(same); see In re Federated Department Stores, Inc., 44 F.3d 1310 (6th Cir. 1995) where an order refusing to disqualify a professional was appealed and reversed, despite conclusion of the case in the absence of a stay pending appeal.}\]


\[\text{11 U.S.C. \textsection 330(a)(3).}\]

\[\text{In re Iannocino, 242 F.3d 36 (1st Cir. 2001); In re Intelogic Trace, Inc., 200 F.3d 382 (5th Cir. 2000); In re Southmark, 163 F.3d 925 (5th Cir. 1999).}\]

\[\text{Pearson v. First NH Mortgage Corp., 200 F.3d 30 (1st Cir. 1999).}\]


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Courts are divided in approving such indemnity language in accountant engagement agreements, with some agreeing if there is an exception for bad faith, self-dealing, willful or reckless misconduct or gross negligence.\(^\text{132}\) Efforts to divert the forum for malpractice claims to arbitrations or bankruptcy or federal court without a jury have likewise received mixed results to date.\(^\text{133}\) Professional conduct rules for attorneys prohibit agreements prospectively limiting liability to a client for malpractice unless the agreement is both permitted by law and the client is independently represented in making the agreement.\(^\text{134}\)

The Third Circuit affirmed retention of the debtor’s financial advisor with an indemnity from the advisor’s own negligence in *United Artists Theatre Co. v. Walton*.\(^\text{135}\) The court evaluated the indemnity from a market perspective and noted that indemnities have become common after the *Merry-Go-Round* settlement of negligent claims against the debtor’s accountants.\(^\text{136}\) But being common does not make provisions reasonable as required under Code §328.\(^\text{137}\) The court evaluated reasonableness from the perspective of Delaware corporate law, focusing on the process of (1) having no personal interest; (2) having a reasonable awareness of all material information reasonably available after considering alternative options, and (3) providing advice in good faith.\(^\text{138}\) The court required that gross negligence be carved out of the indemnity, and rejected a contract term that would have required indemnity if gross negligence was not judicially determined to be the sole source of damages; contractual disputes were likewise carved out of the indemnity.\(^\text{139}\)

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\(^{135}\) 315 F.3d 217 (3d Cir. 2003).  
\(^{136}\) 315 F.3d at 229, citing *In re Merry-Go-Round Enterprises, Inc.*, 244 B.R. 327 (Bankr. D. Mo. 2000).  
\(^{137}\) 315 F.3d at 230.  
\(^{138}\) 315 F.3d at 232-33.  
\(^{139}\) 315 F3d at 23-33; see *In re Baltimore Emergency Services II, LLC*, 291 B.R. 382, 387-86 (Bankr. D. Md. 2003) following *United Artists*, and approving a financial advisor’s indemnity on the condition that a provision be changed that had required indemnification if damages were not found to have been primarily caused by gross negligence, and that may have provided for indemnity of contract disputes.
Conflicts Issues in Representation of Debtors, Committees, and Creditors under State Ethics Rules and the Bankruptcy Code

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*Any views expressed in this paper do not necessarily represent the views of and should not be attributable to the United States Trustee Program or the U.S. Department of Justice.
1. Bankruptcy Code requirements for debtors’ counsel

1.1 Section 327 of the Bankruptcy Code

Section 327 of the Bankruptcy Code provides that debtors may employ attorneys that (a) do not hold or represent an adverse interest to the estate, and (b) are disinterested persons. The term “adverse interest” is not defined in the Code, and courts have applied various definitions. Most courts look to the motivation of debtor’s counsel to act. See, e.g., In re Martin, 817 F.2d 175, 179 (1st Cir. 1987) (asking whether debtors’ counsel possesses “a meaningful incentive to act contrary to the interests of the estate and its sundry creditors”); In re Consolidated Bancshares, Inc., 785 F.2d 1249, 1256 (5th Cir. 1986) (adverse interest is one that “may engender conflicting loyalties”). The Third Circuit has adopted a rule that distinguishes between potential and actual conflicts: (1) where an actual conflict exists the attorney should be per se disqualified (2) where a potential conflict exists, the court has discretion to disqualify the attorney; and (3) disqualification is improper for mere appearance of a conflict. In re Marvel Entertainment Group, Inc., 140 F.3d 463, 476 (3d Cir. 1998).

However, some courts have found that there is no such thing as a benign “potential” conflict and have rejected the potential/actual dichotomy. See In re Kendavis Indus. Int’l, Inc., 91 B.R. 742, 753 (Bankr. N.D. Tex. 1988) (“the concept of potential conflicts is a contradiction in terms. Once there is a conflict, it is actual—not potential.”). The Kendavis court held that where an attorney agrees to protect the interests of management, a shareholder, or any control person of the debtor, the attorney has an actual conflict which requires disqualification.

Disinterestedness is defined in section 101(14) 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 interests 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. 11 U.S.C. § 101(14). One issue that occasionally arises is whether counsel seeking to be employed under section 327(a) may be employed if it holds a prepetition claim and is thus a creditor. Most courts considering this issue have held that attorneys with prepetition claims are prohibited from being employed as professionals because they are not disinterested. E.g., In re Pierce, 8089 F.2d 1356, 1362-63 (8th Cir. 1987); In re E. Charter Tours, Inc., 167 B.R. 995, 996 (Bankr. M.D. Ga. 1994) However, some courts have read section 1107, which provides that previous employment does not disqualify a professional from employment under section 327 solely because it represented the debtor pre-petition, to permit employment of counsel with a pre-petition claim against the estate. E.g., In re SBMC Healthcare, LLC, 473 B.R. 871 (Bankr. S.D. Tex. 2012); In re Talsma, 436 B.R. 908 (Bankr. N.D. Tex. 2010).

Because directors and officers are considered insiders under section 101(31), the statute appears to disqualify them from acting as professionals. Sometimes, however, in other contexts, courts have been asked to consider whether an officer is really an insider. While titles generally control, some courts have looked beyond the title at whether the officer exhibited control. Compare Brandt v. Tablet Divito & Rothstein, LLC (In re Longview Aluminum LLC), 419 B.R. 351, 355 (Bankr. N.D. Ill. 2009) (under section 101(31) of the Code, “directors” or “officers” of
a corporation are insiders regardless of ability to control the corporation) with *In re Foothills Texas, Inc.*, 408 B.R. 573, 585 (Bankr. D. Del. 2009) (title of “vice president” creates a presumption that the person is an officer which can be rebutted by a showing that the person did not participate in active management of the debtor) and *In re NMI Sys. Inc.*, 179 B.R. 357, 370 (Bankr. D.D.C. 1995) (defining an officer as any person who has “undue influence over the debtor’s actions”).

Finally, section 101(14)(c) contains what is known as the “catch-all” provision, defining an insider as anyone with 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 . . .” The Third Circuit has stated that this provision is intended to encompass anyone who “in the slightest degree might have some interest or relationship that would even faintly color the independent and impartial attitude required of an attorney or debtor professional.” *In re BH&P Inc.*, 949 F.2d 1300, 1308 (3d Cir. 1991). Other courts have adopted similar definitions. *See Kravit, Gass & Weber, S.C. v. Michel (In re Crivello)*, 134 F.3d 831 (7th Cir. 1998); *In re Kobe Real Estate, LLC*, 2011 Bankr. LEXIS 3266 at *16 (Bankr. S.D.C. Aug. 31, 2011).

### 1.2 Representing multiple debtors in jointly administered case

As any chapter 11 practitioner will recognize, affiliated debtors often have intercompany loans or financial arrangements that give rise to claims by and against affiliated debtors. Can the same attorney represent debtors that have claims against each other? Many courts adopt a “wait and see” fact-based approach to determine the extent to which additional professionals are necessary in cases where individual debtors have claims against one another. The rationale for this approach is that a per se rule requiring appointment of independent professionals to represent each individual debtor in all cases where there are intercompany claims would burden estates with insurmountable administrative expenses. *In re Adelphia Commun. Corp.*, 342 B.R. 122, 128 (S.D.N.Y. 2006); *see also In re BH&P Inc.*, 949 F.2d at 1322; *In re Rentfrew Ctr., Inc.*, 195 B.R. 335, 342 (Bankr. E.D. Pa. 1996); *In re Mulberry Phosphates, Inc.*, 142 B.R. 997, 998 (Bankr. M.D. Fla. 1992); *In re Global Marine, Inc.*, 108 B.R. 998, 1002 (Bankr. S.D. Tex. 1987); *In re Guy Masonry Contractor*, 45 B.R. 160, 166 (Bankr. D. Ariz. 1984); *In re Int’l Oil Co.*, 427 F.2d 186, 198 (2d Cir. 1970).

While many courts have found joint representation of affiliated debtors with intercompany claims is permissible, unusual or egregious facts may require retention of separate counsel. For example, in *Quarles & Brady, LLP v. Maxfield (In re Jennings)*, 199 Fed. Appx. 845 (11th Cir. 2006), a law firm was disqualified from serving as counsel to eleven affiliated debtors where one of the debtors depleted its assets despite another debtor’s secured claim against those assets. In *In re JMK Constr. Group, Ltd.*, 441 B.R. 222 (Bankr. S.D.N.Y. 2010), four related debtors sought to retain the same counsel. A judgment had been entered against the debtors in an unrelated proceeding, which resulted in the debtors having rights of contribution among one another. *See id.* at 225. The debtors also had intercompany claims with each other. *Id.* at 227. The court held that the contribution and intercompany claims prohibited joint representation by the same lawyer under section 327(a). *Id.* at 233-37. It may be that anything more than garden-variety intercompany claims will result in the need for separate counsel.
An Analysis on Conflict Issues in Debtor Representation

By Edward L. Schnitzer & Anting J. Wang

As opposed to the standard two-party plaintiff-defendant model which is commonly encountered in commercial litigation, bankruptcy cases involve a wide array of parties with diverse interests that may coincide and yet diverge in the same matter. If an attorney should be so fortunate as to be selected for representation by multiple parties in a bankruptcy proceeding, then that practitioner might face difficult questions when evaluating potential conflicts of interests or ethical issues that arise. In some cases, the representation may be challenged in a longitudinal manner, in which the attorney’s past representations may conflict with the issues at hand. In other cases, representation may be challenged in a latitudinal manner, in which current conflicts may or may not bar a potential representation.

In general, courts utilize a totality of circumstances approach when evaluating potential simultaneous representations. Factors which may be considered include the relationship between the parties; the extent of the parties’ interactions; the size of the debt at issue; and the appearance of impropriety as considered within the context of the Model Rules of Professional Conduct and relevant provisions of the Bankruptcy Code (the “Code”). Part One of this article provides an analysis of the law governing debtor representation and sets forth two representative scenarios. Part Two focuses primarily on issues pertaining to creditor and creditors’ committee representation.

GOVERNING LAW

Representation as debtors’ counsel in bankruptcy proceedings is chiefly governed by Section 327(a) of the Code. The section provides in relevant part:

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


Section 327(a) appears to impose two requirements on a trustee or debtor in possession seeking to employ counsel: (i) that the attorney does not hold or represent an interest adverse to the estate, and (ii) that the attorney is disinterested. The word “disinterested” is a term of art, defined in section 101(14) of the Code as, among other things, not having “an interest materially adverse to the interest of the estate . . . .” 11 U.S.C. § 101(14) (2008). Thus, the First Circuit has noted that “the twin requirements of disinterestedness and lack of adversity telescope into a single hallmark.” In re Martin, 817 F.2d 175, 181 (1st Cir. 1987); see also In re BH & P, Inc., 949 F.2d 1300, 1314 (3d Cir. 1991).

However, neither of the aforementioned two prongs are well-defined nor does there appear to be any golden rule to determine whether an impermissible conflict exists. Instead, courts may focus on the individual facts of each case when faced with a conflict.

A. The Totality Of The Circumstances

Courts generally evaluate each circumstance on a case-by-case basis, adopting a wide-screen view of the facts underlying a hypothetical conflict. Considerations include the nature of disclosure of the conflict made at the time of appointment; whether the interests of the related estates are parallel or conflicting; and the nature of the inter-debtor claims made. In re BH & P Inc., 949 F.2d 1300, 1316 (3d Cir. 1991). Other factors may include the existence of interlocking interests between the parties; the size of the debt at issue; the existence of inter-party guarantees; and whether assets are collateralized discretely or across various asset categories. In re Amdura Corp., 121 B.R. 862, 867 (Bankr. D. Colo. 1990).
In general, courts favor the totality approach over an alternative method which distinguishes between actual and potential conflicts. This is because the difference between present and hypothetical conflicts may be semantic as well as problematic to apply in real-time. See In re Angelika Films 57th, 227 B.R. 29, 39 (Bankr. S.D.N.Y. 1998) (“The distinction between ‘potential’ and ‘hypothetical’ conflicts merely confuses the analysis, and several courts have rejected it as artificial.”); In re Kendavis Indus. Int'l, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988) (finding that the concept of potential conflicts is a contradiction; once there is a conflict, it is actual, not potential). These courts instead focus on the facts of each case to determine whether an attorney has an adverse interest without limiting labels. See, e.g., In re Leslie Fay Cos., 175 B.R. 525, 532-33 (Bankr. S.D.N.Y. 1994) (rejecting the actual/potential dichotomy and observing that courts should focus on the facts of a case when reviewing retention applications).

However, some courts still utilize the actual/potential paradigm and it may be necessary to frame your argument in these terms. See In re Jade Mgmt. Serv., No. 09-2800, 2010 U.S. App. LEXIS 14125 (3d Cir. May 4, 2010) (focus of inquiry is whether there is an actual conflict of interest); In re McKinney Ranch Assocs., 62 B.R. 249, 255 (Bankr. C.D. Cal. 1986) (remote potential conflict should not result in disqualification). Additionally, other opinions appear to discuss both models in their opinions and/or to conflate the two standards. See In re Hoffman, 53 B.R. 564, 566 (Bankr. W.D. Ark. 1985) (“Whether … an actual disqualifying conflict exists must be considered in light of the particular facts of each case.”). Accordingly, it is prudent to research the individual holdings of your judge and potentially present arguments under both paradigms when making a case for simultaneous representation.

**REPRESENTATIVE CONFLICTS**

**A. An Attorney Likely May Represent Multiple Debtors Simultaneously**

With the increasing size and complexity of reorganization cases, the most efficient and effective way of administering multiple-debtor cases may be the use of a single law firm, professional or coordinated group of professionals. In re BH & P Inc., 949 F.2d 1300, 1310 (3d Cir. 1991). Thus, to conserve estate assets, courts will permit multiple-debtor representation but also evaluate the facts surrounding the representation to protect the integrity of the bankruptcy process. In re Global Marine, Inc., 108 B.R. 998 (Bankr. D. Tex. 1987) (counsel permitted to represent debtor and its subsidiaries in consolidated chapter 11 case where debtors functioned as one enterprise that operated for the benefit of the whole, and where, during the course of counsel's representation of debtors, there existed a unity of interest and singleness of purpose on debtors’ part).

Even when there are inter-company debts, it is standard practice to allow multi-debtor representation such that estate assets may be conserved. See, e.g., In re Int'l Oil Co., 427 F.2d 186, 187 (2d Cir. 1970) (the existence of intercompany claims by itself was not a basis "to saddle these estates with the expense of separate trustees and trustees' attorneys"); In re O.P.M. Leasing Serv., Inc., 16 B.R. 932 (Bankr. S.D.N.Y. 1982) (declining to remove trustee from stewardship of consolidated bankruptcy proceedings of debtors despite existence of an inter-debtor claim as the case was a well-progressed, complex bankruptcy proceeding where disclosure of potential conflicts had been made at the time of appointment without objection, and it appeared that defendants’ later removal motion was a litigation tactic). Instead, in order to deal with cross-debtor claims, a bankruptcy plan may consolidate a parent and its subsidiaries in consolidated chapter 11 case where debtors functioned as one enterprise that operated for the benefit of the whole, and where, during the course of counsel's representation of debtors, there existed a unity of interest and singleness of purpose on debtors’ part).
B. An Attorney Likely May Not Represent A Debtor And The Principals Of Such Debtor Simultaneously
Because officers and directors of debtors may be defendants in actions brought by a trustee, simultaneous representation of a debtor and the principals of such debtor is often prohibited. For example, in In re Ginco, Inc., 105 B.R. 620 (D. Colo. 1988), the trustee filed an application for approval of the appointment of special counsel to the trustee in prosecuting claims against a lender, as well as for appointment of that same counsel on behalf of the debtor’s principal shareholder. The bankruptcy court authorized such an appointment because it viewed the trustee and the shareholder as sharing a common interest in prosecuting litigation against the debtor’s lender. However, the district court overturned such appointment, noting that “an attorney may not hold or represent an interest adverse to the estate in any matter” in accordance with section 327(a) of the Code. Id. at 621 (emphasis in original). The fact that the shareholder could be a potential target for claims of corporate mismanagement in the future precluded the dual representation of the shareholder and the trustee. See also In re Occidental Fin. Group, Inc., 40 F. 3d 1059 (9th Cir. 1994) (attorney cannot represent debtor and principals of debtor (who were also creditors of debtor) simultaneously); In re Johore Inv. Co., Inc., 41 B.R. 318 (Bankr. D. Haw. 1984) (special counsel not allowed to represent both the debtor corporation and its principal owner); Roger J. Au & Son, Inc. v. Aetna Ins. Co., 64 B.R. 600 (Bankr. N.D. Ohio 1986) (attorney simultaneously representing debtor corporation and its sole shareholder disqualified under Code of Professional Responsibility for creating appearance of impropriety). But see In re Jade Mgmt. Serv., No. 09-2800, 2010 U.S. App. LEXIS 14125 (3d Cir. May 4, 2010) (counsel permitted to simultaneously represent debtor and debtor’s sole shareholder who had guaranteed the debtor’s secured debt where it appeared substantially certain that all secured claims would be satisfied in full).

Conclusion
There are no per se rules as to when simultaneous representation is forbidden. Instead, courts generally consider the totality of the circumstances, including the relationship between the parties, the extent of any interactions and the size of any debts at issue. In addition, practitioners would be wise to avoid the appearance of impropriety when considering any potential representation.

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A “springing recourse guaranty” is a guaranty by a third party that springs into effect as to the guarantor upon the occurrence of some act by the entity, such as the filing of a bankruptcy petition. Informally referred to as a “bad boy” guaranty, these are usually required to be signed by directors or officers (an “insider”) and have been upheld by the courts in a number of different contexts, including the filing of bankruptcy by the corporation. As a result, “bad boy” guaranties have become an increasingly popular tool for lenders and create potential ethical dilemmas for commercial lawyers.

**Lichtenstein**

A recent case from New York highlights the potential minefield of “bad boy” guaranties for a transactional attorney. In *Lichtenstein, et al. v. Willkie Farr & Gallagher LLP, et. al.*[1] the New York State Supreme Court addressed a “bad boy” guaranty arising out of a bankruptcy filing. David Lichtenstein, together with other investors, purchased Extended Stay Inc. (ESI) for approximately $8 billion. Lichtenstein was the manager of ESI, as well as its CEO and board chairman. Lichtenstein signed guaranties that provided for $100 million in personal liability in the event that ESI filed for bankruptcy.

In 2008, ESI was faced with a liquidity crisis and hired Weil, Gotshal & Manges LLP as counsel, which referred Lichtenstein to Willkie Farr & Gallagher to represent him in his capacity as board chairman. Weil advised ESI to file for bankruptcy to prevent ESI’s waste of assets. Willkie agreed but cautioned Lichtenstein that a failure to authorize and file a corporate bankruptcy subjected him to potential uncapped liability for breach of his fiduciary duty in exposing its assets to waste, thereby diminishing the recovery of creditors. After ESI filed for bankruptcy, the lenders filed a suit to enforce the “bad boy” guaranties. Lichtenstein then brought a suit against Willkie, which alleged breach of fiduciary duty and legal malpractice in advising Lichtenstein to

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1 This article was originally published in the *Ethics & Professional Compensation Committee Newsletter for the American Bankruptcy Institute*, Vol. 10, Number 5 / August 2013, and is available at [http://www.abiworld.org/committees/newsletters/ethics-and-professional-compensation/vol10num5/arise.html](http://www.abiworld.org/committees/newsletters/ethics-and-professional-compensation/vol10num5/arise.html)
support the corporate bankruptcy filing. Willkie filed a motion to dismiss for failure to state a cause of action.

The court held in Willkie’s favor after finding that the firm provided reasonable legal advice when they notified Lichtenstein of the potential uncapped liability for waste. As a result, the complaint failed to state a claim and was dismissed. Although the result for Willkie was favorable, the Lichtenstein case emphasizes the serious conflict issues raised by “bad boy” guaranties. One such ethical dilemma for a transactional practitioner is whether an attorney should represent both an insider and a corporate entity when a lender demands a springing recourse guaranty as part of a financing.

Is Representation of Both an Insider and the Entity Appropriate in Connection with a Springing Recourse Guaranty?

Pursuant to Rule 1.13 of the Model Rules of Professional Conduct, an attorney may represent both an organization and any of its directors, officers, employees, members, shareholders or other constituents subject to the provisions of Rule 1.7. Model Rule 1.7 states that if “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,” the representation should be declined unless the following four criteria are met:

1. the lawyer reasonably believes that he or she will be able to provide competent and diligent representation to each affected client;
2. the representation is not prohibited by law;
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.

If a lawyer cannot meet any of the first three criteria, the conflict is nonconsentable. However, common representation is permissible where the clients are generally aligned in interest even though there is some difference in interest among them. A concurrent conflict can be waived if the clients give informed consent in writing, including providing the clients with a reasonable opportunity to seek the advice of independent legal counsel.

If a lender is pushing for a “bad boy” guaranty, there is a concurrent conflict because the guaranty creates a disincentive for an Insider to consent to a bankruptcy if a corporate entity is in distress. That conflict, however, is a future conflict. When the loan is originated, the interests of the insider and the entity are usually aligned for the purpose of making the loan. Accordingly, the origination of the loan is a consentable conflict and one that can be waived by informed consent. Identifying the potential future conflict in writing and providing both the entity and insider with a reasonable opportunity to seek the advice of independent counsel should be sufficient to allow
the attorney to represent both the entity and the insider for the limited purpose of originating the note.

The attorney may, however, be barred from representing either the corporation or the insider in the event of future financial distress. In the event that the corporation struggles, as ESI did in the Lichtenstein case, the “bad boy” guaranty puts the insider and the corporation in direct conflict. The entity’s best interest might be a bankruptcy filing, but the guaranty that springs into effect is, on its face at least, not in the insider’s best interest. While the Lichtenstein court ultimately held that under Delaware law, the best interest of the insider and the entity were aligned due to potential uncapped liability on an insider for waste of assets, when a guaranty punishes an insider for making a decision in the entity’s best interest, it is still likely that Rule 1.7 would forbid the representation of both parties at that point.

Conclusion

Representing both the borrowing corporation and its insiders as the corporation obtains financing represents a present consentable conflict as soon as a guaranty is on the table because while the financing may be in the corporation’s best interest, the guaranty has negative potential repercussions to the insider. This consentable conflict can become nonconsentable in the event that the corporation suffers future financial distress because the negative ramifications personally to the insider are in conflict with his or her duty to the corporation. While the initial conflict may be waived by informed consent, attorneys should identify the potential future risks of default to both the corporation and the insider in the event of default, in addition to the present conflict, in the informed consent letter. It might be worth retaining independent counsel for the insiders at the outset of the loan and guaranty negotiations in order for corporate counsel to remain free from the conflict and ensure counsel’s ability to represent the entity in the event of future financial distress.

Endnotes:
[1] 652092/12, NYLJ 1202597925188, at *1 (Sup., N.Y., decided April 22, 2013).
[3] Id.

Disclaimer

These materials are intended for general informational purposes only. Accordingly, they should not be construed as legal advice or legal opinion on any specific facts or circumstances. Instead, you are urged to consult counsel on any specific legal questions you may have concerning your situation.
CONFLICTS OF INTEREST IN BANKRUPTCY PRACTICE

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CONFLICTS OF INTEREST FOR BANKRUPTCY ATTORNEYS

I. INTRODUCTION

What is a “conflict of interest,” and why is everyone so hyper about it? Licensed lawyers are given some very special powers. When we become attorneys, we become officers of the courts of the state granting the license and of the courts affirmatively “admitting” us to their respective bars pursuant to that license (e.g., federal courts).

The law license allows us to represent (usually “for pay”) the property rights and legal interests of others while we, in essence, are allowed to stand aloof from the embattlement of interests. Not that attorneys do not become viscerally, laboriously, and even emotionally, engaged in the tug-of-war between the actual adversaries, but, as the late Sam Passman once said to a young associate: “Always remember, they’re not talking about your money.”

That advice may not be as flippant as it sounds. In the same way emergency room doctors and nurses are simply more effective in treating their trauma patients if they are not, themselves, vicariously wounded, so are attorneys most effective when they are able to retain a certain professional detachment from the trials and tribulations of their clients – serving their best interests, of course, but never actually becoming one of the adversaries, per se, in the legal conflict.

In exchange for this professional immunity from the struggles our clients and their adversaries must endure, society demands of all attorneys, through well-settled rules we will be talking about below, certain minimum standards of conduct. These rules are not window dressing. They lie at the heart of what has allowed our profession to survive, and even thrive, over a sizeable part of human history.

The expectations of society are:

(1) that the relationship between an attorney and client be one of complete trust and openness (fostered by the attorney/client privilege that attaches to communications between the two) – and that the attorney not create circumstances that suggest a weakness in that trust,

(2) that the representation of a client’s interests be zealous and to the fullest extent permitted by law, and

(3) that the confidences shared between client and attorney, in the course of the representation, always be respected, protected, and never thereafter disclosed.

To codify these expectations, specific rules of behavior have developed under the category of what we call “Conflicts of Interest.” In a very general sense, these are rules society imposes on us in order to cement the “trust” relationship between lawyer and client, and to assure that the attorney remains undistracted in his or her devotion to the best interests of any person or entity the attorney claims as a client. A conflict of interest is, in a sense, a harmful distraction (or potential distraction) that could dilute the effectiveness of an attorney’s efforts to pursue the client’s interests or could thwart or even derail the loyalty to that client that society expects and demands.

That sounds easy – so where’s the problem? The problem is that there will always be a “dynamic tension” among at least four “moving targets” of conduct: (a) the lofty “conflict rules” which govern attorney conduct, (b) the permit to relax some parts of the rules with the informed consent of the affected parties, (c) the need for attorneys to retain their professional independence from their clients without lowering the level of trust, and (d) the necessity to earn a living by accepting new clients, new matters, new business.

II. WHERE DO THESE RULES COME FROM?

There should be a short answer for that question, but it’s a bit complicated – especially in Texas.

A. The Texas Rules.

Texas lawyers must abide by (i.e., must not violate) the Texas Disciplinary Rules of Professional Conduct (which we will call the “Texas Rules”). There’s no question about that. If you don’t have a copy at your desk, it might be a good idea to at
least bookmark them on your computer’s Internet interface “Favorites.”

Texas Rules 1.06 through 1.09 address “conflicts of interest” directly.

Texas Rule 1.06 provides us with the “general rules of conflicts of interest.”

Texas Rule 1.07 addresses the specific practice of an attorney’s acting as an “intermediary” between and among two or more clients seeking a common purpose or a mutual resolution of legal issues.

Texas Rule 1.08 addresses prohibited transactions between attorney and client.

Texas Rule 1.09 gives the special conflicts standards pertaining to “former clients.”

The Texas Anomaly. Texas Rule 1.062 is central to our discussion at this point. Because it is not worded with altogether unmitigated clarity, it is often “summarized” as to its effect as opposed to being quoted. Here’s what it actually says:

Texas Rule 1.06

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

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

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

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

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

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

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

Part (a) is clear enough (e.g., an attorney cannot represent both plaintiff and defendant in a litigation matter). But part (b) often confuses the reader at first, because the scenario it is prohibiting is stated in something of a backward way. Most readers will break it down successfully by taking it, one step at a time, from the end to the beginning.

“If my law partner is representing Client A in a matter against adversaries X, Y and Z, and X later comes to me and asks me to represent him in a new matter against Client A, I have to turn down that tendered representation if I conclude that this second (“new”) matter is related, in some substantive way, to the already pending matter in which Client A is our firm client and Client X is Client A’s adversary.”

This refusal is required by the rule because (in the rule’s own language) the new matter in question (where X would become our client) is “substantially related” to a “matter” (the pre-existing matter) in which “that person’s interests” (X’s interests) are already “materially and directly adverse to the interests of another client” (being Client A).

Restated in the affirmative, if the newly tendered matter, in which the new client would be directly and materially adverse to a current client of the firm (“Client A”), is factually unrelated to any current or previous representation of Client A, there is no conflict of interest, and no waiver or consent of Client A is required. Or, put another way, a Texas lawyer can become adverse to a current client, without a

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1 Go to: www.texasbar.com/ContentManagement/ContentDisplay.cfm?ContentID=13942 (I wish the State Bar of Texas would show the date of this officially published edition of the rules so we would never question whether we are looking at “the most recent” version. For now, I’m assuming that, if it’s on their own website, it must contain any recent revisions.)

2 Texas Disciplinary Rules of Professional Conduct, Rule 1.06
waiver, so long as the new matter does not relate, in substance, to any other matter where the firm is representing that current client.\(^3\)

While the “Texas Rule” did not exactly declare open season for “suing ones own clients on unrelated matters” (Texas attorneys still need to clear the “adverse limitation” hurdle posed by part 1.06(b)(2) of the rule),\(^4\) it did create what still appears to be a unique opening for Texas attorneys to become directly and materially adverse to their own current clients without consent\(^5\) – *something not found in the attorney conduct rules of any other state.*

Interestingly, after articulating a rule that permits Texas lawyers to sue their own clients, the Comments to the Texas Rules urge us not to actually do it:

Ordinarily, it is not advisable for a lawyer to act as advocate against a client the lawyer represents in some other matter, even if the other matter is wholly unrelated and even if paragraphs (a), (b) and (d) are not applicable. However, there are circumstances in which a lawyer may act as advocate against a client, for a lawyer is free to do so unless this Rule or another rule of the Texas Disciplinary Rules of professional conduct would be violated. For example, a lawyer representing an enterprise with diverse operations may accept employment as an advocate against the enterprise in a matter unrelated to any matter being handled for that enterprise if the representation of one client is not directly adverse to the representation of the other client. The propriety of concurrent representation can depend on the nature of the litigation. For example, a suit charging fraud entails conflicts to a degree not involved in a suit for declaratory judgment concerning statutory interpretation. [Comment 11 to Texas Rule 1.06]

The above is not the final word, however, in U.S. Bankruptcy Courts located in the State of Texas.

\(B. \text{ The Federal Precedent for Texas Lawyers: The Dresser Doctrine.} \)

In 1992 the Fifth Circuit took note of the unique liberality of the Texas Rule and, in the *Dresser* decision,\(^6\) imposed on Texas lawyers practicing before federal courts the “higher standards” of the ABA Model Rules\(^7\) (including ABA Rule 1.7), requiring consent from an existing client before an attorney can take on a new matter adverse to that existing client, regardless of whether the new matter is related or unrelated to the matters the firm is handling for that existing client.\(^8\)

So, on this one critically important issue of client conflicts, federal judges presiding in Texas must follow the precedent of the Fifth Circuit and hold the lawyers appearing before them to the standards promulgated, interestingly enough, by a non-government organization – the American Bar Association.

ABA Rule 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:

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\(^3\) See *In re Southwestern Bell Yellow Pages, Inc.*, 141 S. W.3d 229 (Tex. App.-San Antonio 2004, no pet.).

\(^4\) In other words, you can sue your own client, without consent, in an “unrelated matter” as long as you can do so zealously and reasonably without fear of breaching your responsibilities to others.


\(^6\) *In re Dresser Industries, Inc.*, 972 F.2d 540 (5th Cir. 1992); Note that at least one Texas appellate judge has articulated (albeit in a dissenting opinion) that the Texas Rules should be interpreted in line with the ABA Rules on this subject: *Delta Airlines, Ind.* v. *Cooke*, 908 S.W. 2d 632 (Tex. App.-Waco 1995, *mand. motion dism’d*).

\(^7\) Go to: www.abanet.org/cpr/mrpc/mrpc_toc.html

\(^8\) See also, *In re American Airlines, Inc.*, 972 F.2d 605, 610 (5th Cir. 1992); and *FDIC v. United States Fire Ins. Co.*, 50 F.3d 1304, 1312 (5th Cir. 1995)(finding ethical rules from various sources are relevant to a federal inquiry regarding attorney disqualification).
(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 tech affected client;

(2) the representation is not prohibited by law;

(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.

So, part (a) gives us the prohibitions, and part (b) tells us how that might change if a valid consent is received from “each affected client.”

Note that the consent provision applies to “each affected client.” This reminds us that, often times, when it’s clear you need to get one consent, you may actually need two. Many attorneys tend to focus solely on the “problem” (pre-existing) client that is presenting a conflict (i.e., impediment) to accepting the newly tendered business. Doing whatever it takes to get that existing Client A to consent to the new representation (a representation adverse to it) – even if successful – can foster a dangerous “barrel vision” on the attorney’s part. Isn’t the new incoming client also “affected” by the situation? In most cases, yes. The new client will want to know that it can place complete trust in its chosen counsel and clearly deserves the respect of receiving full disclosure of the firm’s prior and current relationship (and, thus, continuing loyalty) to its adversary, the pre-existing Client A. The new client must carefully ponder these existing relationships and continuing economic ties, and is free to “go in a different direction” – even if the pre-existing Client A is happy to give its consent to the representation. If, on the other hand, the new client is willing to go forward, adding its own consent to that of Client A, the wise attorney will surely want to have both clients’ consents in writing for future reference (a/k/a “Exhibit A” in any trouble that later arises).

III. WHO OR WHAT IS A CLIENT?

Sometimes it’s very clear who your client is, and is not. At other times, at least for conflicts purposes, it can get murky.

A. The “Former Client”

Should an individual or company who “used to be” a client of your firm always be considered a client for conflicts purposes? Is the “duty of loyalty” continuous? If not, what relaxation of the ABA Rules is permitted for becoming adverse to a true “former client” of the firm?

Under ABA Rule 1.9, an attorney may take on a case against a former client only if the new matter is not substantially related to the case(s) handled by the firm for that former client of the firm. If the two matters are related “substantially,” then the new representation cannot be taken on – absent the informed, written consent of the “former client.”

Thus, the striking distinction between the Texas Rule and the ABA Rule becomes clear. The Texas Rules makes it possible for an attorney to become adverse to a current or former client, so long as there is no substantial relationship between the two (or more) matters in question. The ABA Rules (applicable in bankruptcy courts) permit an attorney to become adverse only to a former client, so long as there is no substantial relationship between the matters in question.

B. That Begs the Question: What Does Substantially Related Mean?

Will you really “know it when you see it?” Since the whole question of becoming adverse to a former client hinges on whether the two matters under the

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microscope are “substantially related,” you would think that question could be easily handled, or at least defined in the rules – but it isn’t. Unfortunately, it is one of the most litigated aspects of conflicts law. Where the proponent of taking on the new matter sees nothing “substantial” in the relationship between the two matters in question, the “former client” often does – and moves to disqualify.

Illustrative of the wide spectrum of possible opinions in a given case, the justices of the Supreme Court of Mississippi, in an interesting case decided in 2001, were sharply divided over the question of “substantial relationship” when comparing (a) a matter of litigation with (b) various property transfers undertaken by parties in contemplation of that litigation. The majority was comfortable that the two cases were substantially unrelated – thereby requiring no consent to the adversity – and thereby refusing to disqualify the law firm in question. The minority forcefully disagreed.

One area of inquiry that seems clearly relevant in such deliberations is whether the attorney in question obtained any confidential information during the earlier representation (of the “former client”) that could now be used in the matter adverse to that former client. In fact, Comment [3] to ABA Rule 1.9 incorporates this factor as part of the analysis, noting that two matters would be substantially related “if they involve the same transaction or legal dispute or if there otherwise is a substantial risk that confidential factual information as would normally have been obtained in the prior representation would materially advance the client’s position in the subsequent matter.” Notice that no actual sharing or use of the confidential information is required – only that, if used, that information would be helpful to the new client’s case.

The comment goes on to offer one common sense “escape hatch:” “Information that has been disclosed to the public or to other parties adverse to the former client ordinarily will not be disqualifying.” So, if, without the help of the lawyer in question, the new client already knows the confidential information previously disclosed to the lawyer by the former client, the substantially-related standard may not be implicated, and proceeding without the consent of the former client would not violate Rule 1.9(a).

Also, a significant passage of time (between the old matter handled for the former client and the new matter adverse to the former client) should always be considered as a factor in making the determination. Sometimes it helps, and sometimes it doesn’t.

C. The “Client-Affiliate” Client?

Businesses can be complex conglomerations of legal entities (“corporate families”), often acting in concert with each other, and sometimes operating under common governance structures. This reality raises the important consideration of whether representing one member of the conglomeration

11 Williams v. Bell, 793 So. 2d 609 (Miss. 2001).
automatically makes any other member ("affiliate") a “client” of the firm. Put another way (and perhaps exposing my bias), if a business enterprise goes to such great lengths to establish separation and distinction between and among its component parts to prevent shared liability (e.g., “wholly-owned subsidiaries,” etc.), can attorneys not follow suit, ethically, and treat them as separate entities for conflicts purposes — or are we required, in effect, to collapse their “separateness” and treat them all as one client?

Obviously, this is a huge issue with well-reasoned judicial opinions on the subject literally all over the map, some holding to strict prohibitions against becoming adverse to a client’s affiliates, and others rejecting any per se standard and endorsing, instead, a case-by-case examination of the facts as the better way to come to a fair and proper ruling on disqualification.

Fortunately, the official comments to the ABA Rules conclude that representing one corporate member/affiliate does not “normally” create a conflict of interest when becoming directly adverse to an affiliate on a substantially unrelated matter. Insert “substantial relationship” into the fact pattern, and you will probably have to collapse the two affiliated entities into one for conflicts analysis.


19 ABA Rule 1.7, Comment [34]: “A lawyer who represents a corporation or other organization does not, by virtue of that representation, necessarily represent any constituent or affiliated organization, such as a parent or subsidiary. See Rule 1.13(a). Thus, the lawyer for an organization is not barred from accepting representation adverse to an affiliate in an unrelated matter ....”

Courts that do reject any “per se” rule against becoming adverse to affiliates will usually focus on the actual relationship between the affiliates in question to determine the degree to which it might negatively affect the law firm’s representation. At least two “tests” have developed to help resolve the question: the unity of interest test and the alter ego test.

1. Unity of Interest Test. Sometimes attributed to the 1991 Teradyne20 case from the Northern District of California, this test undertakes a qualitative analysis to determine if the affiliates should be treated as one for attorney conflicts purposes. Are the two affiliates supported by the same in-house legal department? Does one individual serve as “general counsel” for the attorney’s client in one matter and “general counsel” for the adverse party in another matter? Does the closeness, or unity of interests, of the two affiliates justify seeing them as a single entity? Would holding otherwise erode the attorney’s duty of loyalty to the client, or the duty of confidentiality, or otherwise diminish the client’s “level of confidence and trust” in its legal counsel?

2. Alter Ego Test. Alternatively, some courts have held that they will only collapse the separateness of the affiliates in question if the facts would justify holding their “corporate separateness” as a legal fiction. In other words, are the two affiliates (e.g., parent and subsidiary) alter egos of each other in a way that, for other purposes, their entire corporate separateness could be legally disregarded and all general liabilities shared between and among them? If so, then these courts hold that attorneys should “see them as one” for conflicts purposes, too.

With either test, most courts will agree that a critical factor in making a determination to collapse the affiliates for conflicts purposes will be the likelihood that the law firm in question obtained confidential information that could be used against


the proposed adverse affiliate of a client currently or
previously represented by the firm. 22

Of importance to the Texas bankruptcy practitioner (and in concert with the official comments
to ABA Rule 1.7), the ABA committee on Ethics and
Professional Responsibility addressed the issue of
corporate family conflicts in ABA Formal Opinion
95-390 (January 25, 1995), rejecting any per se
disqualification and holding that a lawyer who
represents a corporate entity is not, by that fact alone,
barred from engaging in a representation adverse to an
affiliate of the client in an unrelated matter, so long as
there is no agreement to the contrary among the
parties and the firm, and so long as the firm in
question is not “materially limited” (i.e., will not be
tempted to “pull its punches” because of sub-surface
loyalties to the adverse party affiliate of a firm client
in other matters).

D. The “Surprise” Client?
Face it. Sometimes people think you are their
attorney when you had no such understanding.
What’s worse, sometimes they are correct – and can
assert conflicts rules against you, in motions to
disqualify, just as effectively as “the clients you know
about.” Who are these mystery clients?

1. The Interview Client.
Lawyers often undergo preliminary consultations
with prospective clients without ever taking on the
representation. If, later on, the lawyer becomes
adverse to the consulted party, the prospect of a
motion to disqualify is often present. Who wins in the
ensuing argument of “I became your client! You can’t
sue me now.” – “Oh no you didn’t, and, yes, I can!”

The standards and considerations employed by
courts to resolve such disputes include such factors as the length and breadth of the communications
between prospective client and attorney, the
prospective client’s intent and reasonable
understanding, whether the prospective client supplied confidential information to the lawyer, and
whether the lawyer provided preliminary legal advice
during the consultation. So, there is no bright line
test. Some courts side with the aggrieved client, 23 and
others with the shocked attorney. 24

Best practice: Let a prospective client know at the outset of your discussions not to share with you any information that might be confidential in nature. Then, if your initial conversations, communications, and consultations do not blossom into a full-fledge attorney-client relationship, find some polite but clear way to document the absence of such relationship.

Send a letter. Confirm that, no matter how it made
your day just to meet them in person, no representation is being undertaken and no confidential information was exchanged. File a copy of that letter in a permanent file that is easy to access in the future.

2. The Previously Misidentified Client.
Sometimes a law firm will take on one discrete
element of a larger transaction for “the real client”
which, unintentionally, gives additional parties a
legitimate right to claim the status of “client of the
firm.” This is fundamentally a failure on the lawyer’s
court to properly identify who she does and does not
represent in a complex matter. A great example is a
case decided by the Supreme Court of Texas in
1998, 25 where the law firm’s representation of a large
company in a complex merger and acquisition was
allowed, for convenience, to expand slightly into
advising the client’s chief executive officer as to his
employment contract and other benefits. That was
enough for the Supreme Court to find an attorney-
client relationship existed, which was sufficient to

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23 See, e.g., Richardson v. Griffiths, 560 N.W.2d 430 (Neb. 1997); Griffen by Freeland v. East Prairie, Missouri
Ct. 1999), rev’d on other grounds, 754 N.E.2d 314 (Ill. 2001); Lovell v. Winchester, 941 S.W.2d 466 (Ky. 1997).
LEXIS 7137, 1993 WL 180224 (D. Md. May 24, 1993);
Clark Capital Management Group, Inc. v. Annuity Investors
Life Ins. Co., 149 F. Supp. 2d 193 (E.D. Pa. 2001);
Capacchione v. Charlotte-Mecklenburg Board of
Education, 9 F. Supp. 2d 572 (W.D.N.C. 1998); Butler v.
Romanova, 953 A.2d 748 (Me. 2008); Benchmark Capital
WL 31057462 (Sept. 3, 2002).
25 In re Epic Holdings, Inc., 985 S.W.2d 41 (Tex.
1998).
disqualify the firm from becoming adverse to that individual several years later.26

**Best practice:** Always take care to ensure that non-client participants in a transaction cannot later claim they are former clients of the firm. Utilize a written engagement letter with the “true client” setting forth clearly who is and who is not the client. If there are other entities or individuals who might incorrectly assume they, too, are clients, send them a polite, but clear, “I’m not your lawyer” letter. Keep copies of all such letters in a permanent, easily accessible file.

3. The Migrating Client.

This is an off-shoot of number two above. Say your partner, Joe, in the Austin office once represented X-Stream Bank as “agent bank” in a Southern District chapter 11 case. At the inception of the representation Joe entered “X-Stream Bank” in your firm’s conflicts database as a current client of the firm. A year later you are asked to represent a manufacturing company against a number of lenders, including South Park Bank among others, in the federal district court in Dallas. You clear conflicts, accept the representation, and dive in. Your client invests heavily in your prosecution of the case for a number of months, and you are finally making headway against these predatory lenders. Then South Park Bank files a motion to disqualify your firm. Taken aback, you investigate and find out that Joe’s client X-Stream Bank had been, at some point in the past, quietly absorbed by South Park Bank (or perhaps X-Stream Bank had resigned as agent bank and was “automatically” replaced by the substitute agent, South Park Bank, who asked Joe to continue his fine work). Either way, South Park Bank became a client of your firm, and good ol’ Joe just forgot to update the conflicts system. The ensuing conference call with your manufacturing company client will likely be an unhappy experience for all concerned.

How could this have happened? Simple. At the outset of a representation, good attorneys are usually vigilant in clearing all conflicts before proceeding, using their firm’s computerized conflicts database like a pro. Your partner did a great job of clearing conflicts for X-Stream Bank – he just forgot to go back to square one when, later on down the line, the identity of the client “seamlessly” shifted to some other entity. The ease of transition from one to the other (in the agent bank representation) never triggered his normal instinct to carefully clear conflicts – and to enter the new client’s name into your firm’s conflicts database – before continuing with that representation.

**Result:** You have a current client you had no knowledge of, and it has filed a motion to disqualify you from continuing your adversity against it. **Lacking consent, you will probably have to withdraw.**

**Best practice:** When, in the course of a representation, the identity of a client mutates or evolves to some other name or shifts to another entity altogether, update the firm’s conflicts database accordingly.

IV. ADVERSITY: DIRECT & MATERIAL

If there is one grand prize winner issue firm conflicts counsel have to face time and again, it’s this one. So let’s get started.

Once we understand who the client is, and that in federal courts we cannot become “directly” adverse to a current client, nor “materially” adverse to a former client (or to a firm client’s affiliate) on a matter substantially related to some other matter handled by the firm, the only part of the rule left to examine is: what does it mean to “become adverse?” Is “adversity” easy to spot?

Sometimes, of course, it is easy to spot. Obviously, **plaintiffs** are adverse to **defendants** in litigation. **Borrowers** are directly adverse to their **lenders. Buyers** are directly adverse to **vendors.** But there are many other circumstances in which lawyers represent clients with no clear understanding of whether the representation is actually “directly adverse” to a particular entity, or not. Unfortunately, the ABA Rules do not provide us with a definition of “direct adversity” to help us navigate these waters.

In terms of the ABA Rules, only “direct” adversity calls for implementation of the rule’s provisions (prohibition, absent consent). In terms of the Texas Rule, the adversity must be “direct and material” before requiring the client’s consent. These embellishments of the word “adverse” are important considerations and seem to confirm that there is such thing as “indirect adversity” which would not be an impediment to taking on the case in question. even

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without consent from that current client of the firm — or “immaterial adversity” which, apparently, would not require consent from a former client, even on a matter related to your prior representation. If only these “indirect or immaterial adversities” stood out like sore thumbs — but they don’t. The profession is left to sort out which adversities are direct and material, and which are indirect and/or immaterial.27

“Materiality” must means that the adversity between the parties involves something meaningfully “at stake” in the controversy, something that is of worth or substance. Let’s try an example of possible “adversity” without “materiality.” An insurance company may invite an insured to sue the insurance company for payment of policy limits (something the insurance company knows it cannot avoid in the case), and may even foot the bill for the insured’s lawyer to bring the case. The purpose of the action is to apply res judicata to a resolution that both sides (insured and insurer) have accepted as final. The suit is brought by one attorney, the allegation of liability is lodged, an attorney for the insurance company files a general denial, an agreed judgment is entered by the court, and everyone goes home satisfied. On its face, adversity existed, but the materiality of the adversity was lacking. Nothing of real worth was truly contested and “at stake” in the litigation. Under ABA rule 1.9, it seems the lawyer representing the insured could bring the action, without seeking consent, even if the insurance company “defendant” was once the lawyer’s client in a matter pertaining to this insured and this insurance policy.28

“Directness” of adversity is perhaps the more interesting qualifier of adversity against a current client (and comes up more often than materiality).

Most “direct adversity” questions arise when the, let’s say, “pocket book” of some client of the firm will be (or might be) “adversely affected” by the success of a litigation in which that client is truly a non-participant (i.e., “economic adversity”).

For example: Assume your firm represents an oil and gas production company (AAA) in its transactions with customers and joint interest owners. Another company (BBB) comes to you seeking representation in a large and serious litigation action against a pipeline company (CCC). You accept the case and file suit against CCC, even though CCC also happens to be the sole pipeline service provider to your good client, AAA, and “victory” in the litigation may even put that pipeline company out of business and, consequently, deprive AAA of any means of getting its product to the market place for several months. Even though AAA is not in any way a party to the litigation, the litigation, if successful, will take money out of AAA’s “pocket book.” That economic “pinch” is certainly “adversity” (AAA may even send you a letter pleading with you to drop the case) — but is it “directly adverse?” Should your firm have obtained the consent of AAA29 before proceeding to represent BBB against CCC?

Since in Texas we are effectively governed, in part, by the ABA Rules, let’s look first at a very important official comment for some guidance:

“Loyalty to a current client prohibits undertaking representation directly adverse to that client without that client's informed consent. Thus, absent consent, a lawyer may not act as an advocate in one matter against a person the lawyer represents in some other matter, even when the matters are wholly unrelated. The client as to whom the representation is directly adverse is likely to feel betrayed, and the resulting damage to the client-lawyer relationship is likely to impair the lawyer's ability to represent the client effectively. In addition, the client on whose behalf the adverse representation is undertaken reasonably may fear that the lawyer will pursue that client's case less effectively out of deference to the other client, i.e., that the representation may be materially limited by the lawyer's interest in retaining the current client. Similarly, a directly adverse conflict may arise

27 Interestingly, ABA Rule 1.9, dealing with former clients, prohibits only those representations that are “materially adverse” to the former client and never mentions “direct” adversity. ABA Rule 1.7 is the reverse. It is difficult to reconcile why the language of the two rules, otherwise so parallel, differ in this regard.

28 This is admittedly only a hypothetical attempting to conjure what an immaterial adversity against a former client might look like. If you have a better example, let me know!

29 Sometimes referred to as a “third-party client” (i.e., a client of the firm on other matters, but not a party to the legal action under examination).
when a lawyer is required to cross-examine a client who appears as a witness in a lawsuit involving another client, as when the testimony will be damaging to the client who is represented in the lawsuit. On the other hand, simultaneous representation in unrelated matters of clients whose interests are only economically adverse, such as representation of competing economic enterprises in unrelated litigation, does not ordinarily constitute a conflict of interest and thus may not require consent of the respective clients.”

This official comment is always a helpful one to review closely when an attorney is struggling with the often murky question of “directness” of adversity. It acknowledges what we already know: that the world is a highly interconnected and interdependent complex of interests, and that, importantly, some direct and material adversities as to one opposing party can have unwelcomed economic consequences as to other parties not involved in the adversary proceeding, per se (i.e., “third-party clients”). It is not the attorney’s responsibility to assure that no third party client will be consequently “worse off” if the planned legal action goes well. Competing (or “conflicting”) economic interests in the outcome of a matter are not “direct and material adversity” and thus do not, per se, give rise to a conflict of interest requiring the consent of that “economically affected” third-party client.

This is not to say that a firm might not consider making a potentially sound “business decision” to decline a representation that could ultimately occasion harm to, or economic stress on, a significant existing (but not directly involved) client.

Taken further, however, if part of the firm’s true game plan is to “scheme against” the economic interests of a client on unrelated matters, the “economic adversity” can easily become “direct and material” adversity requiring consent—or disqualification. In other words, the client is not truly an indirect “third party” to the action if the law firm is intending to bring about the adverse economic consequences in question. That is an attack.

That being said, strange things do happen, even when the indirect adversity is not intentional. An interesting question was put to the Philadelphia Bar Association Professional Guidance Committee in July 2009. The law firm represented a real estate developer needing a zoning variance before constructing an office building. A nearby neighbor (who was represented by the same firm in other matters) opposed the zoning application and hired another law firm to fight it. The developer’s law firm asked the committee for an opinion confirming that, hopefully, opposition to the zoning by a “third-party client” did not constitute a direct conflict of interest for the firm. The committee members said they believed it did. Although not a typical conflict scenario, the committee ruled that the neighboring client’s announced intention to fight the application at an upcoming hearing of the city commission was enough to make the law firm’s prosecution of that application directly and materially adverse to the other client and would necessitate obtaining a consent from that client before proceeding.

Here are some typical settings where “direct vs. indirect” adversity questions arise.

A. Corporations vs. Human Beings.

Becoming directly adverse to a corporation, whether in litigation or in negotiations, etc., does not normally mean you are directly adverse to its people (shareholders, officers, directors or employees) – even though you may very well be “indirectly” (economically) adverse to them. I say “normally” because it is always possible for a judge to rule differently under circumstances seen as “special.”

B. Business Competitors.

Helping one client to advance its business in a positive way (such as acquiring a license to conduct business in a particular geographic area, or obtaining regulatory approval of a new product) would naturally be economically disadvantageous to a direct competitor. If you represent both companies “prefer one client over another when economic interests clashed”).

See, e.g., Committee on Legal Ethics v. Frame, 433 S.E.2d 579 (W.VA. 1993).

30 Comment [6] to ABA Rule 1.7
31 See ABA Formal Opinions 05-434 and -435 (Dec. 8, 2004) for further guidance.
33 PBAPGC Opinion 2009-7.
34 ABA Formal Opinion 95-390 (Jan. 25, 1995); ABA Rule 1.13(a)(a corporation is not its owners, officers, et al.).
35 See, e.g., Committee on Legal Ethics v. Frame, 433 S.E.2d 579 (W.VA. 1993).
generally, and so long as the disadvantaged client’s legal rights are not attacked or altered, the adversity should be seen as only “indirect” and requiring no consent.

C. Contingent Debtors.
What if you are asked to represent a creditor against a borrower, and you discover that one of your firm clients guaranteed that debt? If you proceed, are you becoming directly adverse to the client-guarantor? Clearly the relationship with the guarantor should be disclosed to the creditor so it can consent to going forward (accepting the fact that you would never be able to expand the action to include the client-guarantor). But what if the creditor instructs you to bring the underlying action in such a way as to maximize the creditor’s claim against the guarantor for a later date, if such an action becomes necessary? Is that akin to “scheming against a client?” Absent consent from the client-guarantor, a wise attorney might want to decline such a representation altogether.

D. Beauty Contests.
Sometimes there can be only one contestant who will walk away with the crown. Can your firm concurrently represent two or more applicants competing for award of a lucrative franchise or license, when only one applicant can prevail? Are the “interests” of the clients only “indirectly adverse” as “economic competitors?” What if you can help one client “more” if you point out a significant weakness in the application of the other client applicant? Ouch!!! Even with informed consent, an attorney who represents multiple contestants for a winner-take-all “prize” is often asking for trouble.

But what if the relationship between the two prospective clients is “direct” and the subject matter is “material,” but it is not clearly “adverse?” For example, if a borrower gives a promissory note to a lender to memorialize a debt, and both borrower and lender agree that the debt is owed and that installment payments have been timely made, and if the lender is not taking action to “enforce” payment of the note … does the existence of the indebtedness, itself, constitute direct and material “adversity?”

V. OBTAINING A VALID CONSENT
Lawyers and judges often use the term “conflicts waiver,” but the rules prefer the term “client consent.”

Now that you have resolved that the situation before you presents a direct and material adversity to a current client (or a material adversity to a former client on a matter substantially related to your previous engagement) requiring consent, what kind of consent should you consider obtaining, and how should you go about it?

Is it “consentable?” Some scenarios are so conflicting for the attorney that courts will not recognize a client consent, no matter how properly it may have been obtained. With rare exception, an attorney cannot represent a plaintiff and defendant in the same litigation. A client may not consent to a representation that is prohibited by law (e.g., being represented by a disbarred attorney in a contract negotiation is not consentable). A client should not be asked to consent to a multi-party representation where the interests of the parties are unavoidably adverse.

If it is consentable, how do you go about getting a valid consent? The objective will be to obtain a fully “informed” consent from each client (the new client AAA, and the pre-existing client BBB). This means that the attorney will have to explain the situation to the consenting clients in sufficient detail to permit each of them to make a rational, educated decision. Without such information changing hands, any consent received could be invalid.

Why does AAA also need to consent? This client must be given a clear disclosure as to the law firm’s relationship with, dependence upon, and loyalty to, the pre-existing client, who will be approached for “consent to become adverse.” Otherwise, the new client could later become disenchanted with the outcome of the case and believe that one of the problems was the law firm’s pulling punches as to its own pre-existing client … using kid gloves so as not to offend a significant client of the firm.

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36 ABA Rule 1.7(b)(2) and (3).  
37 ABA Rule 1.7, Comment [28] (…a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference in interest among them…”).  
38 ABA rule 1.7, Comment [6] (“The client as to whom the representation is directly adverse is likely to feel betrayed, and the resulting damage to the client-lawyer relationship is likely to impair the lawyer’s ability to represent the client effectively. In addition, the client on whose behalf the adverse representation is undertaken…”)
A. **Step 1: Talking to Yourself.**

Before either client is approached regarding a consent, the attorney must resolve in her own mind that, with the consents required, she can provide competent and diligent representation to each client going forward. This determination must also be “reasonable” (meaning that a similar resolution would likely be reached by any reasonable lawyer under all of the facts and circumstances present in the case – and, hopefully, so would a judge presiding at any future disqualification hearing). If the attorney can comfortably reach the conclusion that going forward with the representation, with consents in hand, would pose no hindrance to her zealous loyalty to the new client, she may then start the process of obtaining the requisite consents.

B. **Step 2: Talking to the New Client … Part A.**

This is where you consult with your new prospective client, AAA, concerning the firm’s pre-existing attorney-client relationship with the adversary (disclosed as fully as possible, given the independent prohibitions on revealing BBB’s client confidences without permission). In other words that conversation should not go like this: “We have a small, technical problem. The firm represents BBB in an unrelated matter … it’s top-secret pre-bankruptcy planning, caused by the fact that in 30 days they are going to lose their largest domestic customer. Don’t let this get out, though, because it’s extremely sensitive and confidential.” That won’t fly. If you can give AAA a reasonably accurate picture of the firm’s relationship with BBB without sharing confidences, and AAA says it still trusts you enough to let you go forward with the representation under those conditions, then you’ve gotten past first base.

C. **Step 3: Talking to the New Client … Part B.**

Next, you will need to plan how to approach BBB (the pre-existing client against whom the new case will be brought). Since BBB’s consent works only when it is “fully informed,” the question arises: “How much will AAA permit me to disclose/expose to BBB regarding its adverse intentions?” That’s a separate question from whether BBB trusts you with the representation in general. Often litigants are happy to keep you on as their lawyer, but want to give no “heads up” to their adversaries that a case is about to be filed. If AAA says it is willing to grant its own consent, but is not willing to let you inform BBB of the impending action, then it’s “game over,” and no enforceable consent from BBB is possible (could you really ask your client, “Would you waive our firm’s conflicts on something that’s about to happen to you, even though I can’t give you any information about what we are being asked to do?”).

D. **Step 4: Talking to the Pre-existing Client.**

If AAA gives you permission to inform BBB of the essential, known facts of the upcoming adversity, you are ready to take the final step – but remember, you are approaching your own client. Courts will probably side with your client in any subsequent dispute that may arise as to the accuracy and/or completeness of this disclosure. You will be expected to fairly communicate sufficient information about (a) the nature of the impending action, (b) the material risks of BBB’s granting its consent, and (c) the reasonably available alternatives to granting the consent. Alternatively, if BBB happens to have a legal department with a general counsel, or is often represented and counseled by another law firm, BBB can simply receive the essential information about the impending legal action and then “go in-house” or to its other law firm for counseling on the pros and cons of granting the requested consent.

If all consents are fully informed and granted, they must then be reduced to writing for future use in the event of troubled attorney-client waters.

E. **Enlightened Self-Interest.**

Sometimes turning down a conflicting case is ultimately the wisest choice. A wise attorney will want to know the rules for obtaining consent to become adverse to a current client (or to a former client on a related subject), but will also carefully assess the long-term costs and benefits to be derived from refusing to become adverse to such clients. This is a “business question,” of course, made with the realization that, if either client (AAA or BBB) turns out to be tremendously injured or offended by the experience of the proceeding, the law firm may well be the “defendant” in a second go-round, regardless of the consents obtained. This is why, despite all of the above steps for becoming directly and materially adverse to current or former clients, many good firms say simply: “We don’t sue our clients … period.”

VI. **“DEEMED CONFLICTS”**

All of the above discusses classic, fairly straightforward conflicts issues that arise in modern legal practices. But conflicts issues can creep up on...
unsuspecting lawyers in non-classic ways, and errors can occur with the best of intentions, opening the Pandora’s Box of conflicts of interest. Each of the following eight scenarios deserves a quick mention in the hope of avoiding such unnecessary nightmares.

A. “It Was Only Discovery.”

Most lawyers understand that suing a client constitutes “becoming adverse” to that client. It is surprising how many lawyers believe anything short of that (like simply deposing a client or cross-examining an adverse witness on the stand, who just happens to also be a client of the firm) is not “directly adverse.” They are usually wrong. Absent informed consent, a lawyer may not compel any form of discovery or testimony from a current client without running afoul of the rules. Under the ABA Rules, “a directly adverse conflict may arise when a lawyer is required to cross-examine a client who appears as a witness in a lawsuit involving another client, as when the testimony will be damaging to the client who is represented in the lawsuit.”

As we’ve seen before, the problems presented here can be two-fold. Not only might the deposed or cross-examined witness/client feel betrayed by his own lawyer, but the represented client may feel equally dissatisfied, perceiving his lawyer to be “really taking it easy” on the adverse witness … “yielding to objections, and carefully avoiding anything that might embarrass the client or make his testimony appear foolish, inaccurate or untrue.” It’s a no-win deal.

Best practice: Obtain the informed consent of the represented client and of the witness/client before embarking on discovery against, or adverse examination of, any client of the firm.

B. “I Know, But I Can’t Say.”

An attorney who obtains confidential information in one matter cannot disclose that information to another client in another matter simply because it would benefit the second client to be privy to the information. In other words, the second client’s “need” for the information clearly does not, per se, permit release of that information. On the other hand, the second (uninformed) client has good grounds to complain of an attorney who has valuable information that she knowingly withheld in the course of the representation. This “guilty knowledge” quandary truly puts the attorney “between a rock and a hard place.”

If the “source” client (that provided the information to the attorney) agrees to its release, the attorney will be free to do so, assuming the consent was competent and informed, but the ABA opinions on the subject make it fairly clear that, upon failure to obtain such a release, the attorney cannot then go to the other client (the one that would benefit from the information) and obtain a “consent to nondisclosure.” This is because a client in that position cannot evaluate the potential usefulness of the information (nor the cost of its non-disclosure) without first being fully apprised of the information – which is the whole point. Courts vary widely on the best course of conduct for an attorney seeking to avoid this “information” conflict. Unfortunately, if the “source” client won’t consent to release, and the “uninformed” client cannot validly consent to nondisclosure, the attorney’s only safe option may be to withdraw altogether from the representation and simply continue to honor the confidentiality of the information in question.

C. The Kryptonite of Conflicts: “Material Limitations”

With all the emphasis on direct and material adversity, and “deemed” adversity, and the potential usefulness of “informed consents” to clear the way through the forest, it is important to note that some

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39 ABA Rule 1.7, Comment [6].
40 ABA Formal Opinion 92-367 (Oct. 16, 1992) concluded concluding that an attorney’s litigation client should be considered “directly adverse” to a witness whose testimony will likely result in some “concrete disadvantage” to the witness. Thus, the lawyer faces a conflict that is disqualifying in the absence of appropriate consent when there is a “concrete disadvantage” to the witness/client. See e.g., Hernandez v. Paicius, 109 Cal. App. 4th 452 (2003). Although in the minority, some courts have sided with the attorney in such cases, such as in Beilowitz v. General Motors Corp., 226 F. Supp. 2d 565 (D.N.J. 2002).
critical conflicts issues are not really based on the “nature” of the adversity at all. Both the Texas Rules and the ABA Rules go further than simply prescribing to whom an attorney may or may not become directly adverse.

Independent of the nature of the adversity presented in the case, a lawyer may not handle any case where “… 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.”

This is the “material limitations” conflict. It comes from whatever circumstance that would have the effect of draining away the commitment and mitigating the effectiveness of the attorney handling the case. It’s a rule as easy to endorse in concept as it is difficult to define, or to prove. Material limitation is truly attorney Kryptonite!

Here’s an example. Assume you, personally, have asserted a claim against PowerCor because you think they have been double-charging you, intentionally or negligently, for electric utility fees for the past three years. They say you are simply wrong. You say you’re going to take this all the way to the PUC! Meanwhile, another attorney in your firm is retained to represent PowerCor on an unrelated matter involving construction of a new warehouse. In this situation, your own personal interests are adverse to PowerCor, but the question is, will those interests, if known to your partner, in any way “materially limit” her representation of that company? If not, then your personal interests would not be “imputed” to the other lawyer, and no “material limitations conflict” would exist. But if your David-and-Goliath quest to have your alleged overcharges refunded gains so much sympathy that your partner no longer cares much whether PowerCor, the client, prevails or not in the construction matter, she is probably “materially limited” in the representation and should withdraw. Overcharges or not, the client deserves to have a zealous, unfettered representation in the matter at hand.

The official comments to the ABA Rule give other examples.

Where one lawyer in a firm could not effectively represent a given client because of strong political beliefs, for example, but that lawyer will do no work on the case and the personal beliefs of the lawyer will not materially limit the representation by others in the firm, the firm should not be disqualified. On the other hand, if an opposing party in a case were owned by a lawyer in the law firm, and others in the firm would be materially limited in pursuing the matter because of loyalty to that lawyer, the personal disqualification of the lawyer would be imputed to all others in the firm.

At least the rules and judicial determinations concerning material limitations seem to recognize that a lawyer, who reasonably determines that she is in no way hindered by the circumstance in question, may safely proceed with an otherwise permissible representation. If a hindrance is present, it is still possible to proceed so long as, at minimum, the lawyer “reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client” and each affected client is informed and consents, in writing, to going forward with the representation.

D. Lawyer-as-Witness Issues.

When may a lawyer take the stand in a case he is handling before a court? Even when there are no other grounds for disqualification of the lawyer, ABA Rule 3.7(a) generally prohibits a lawyer who is likely to testify at trial from also acting as an advocate on behalf of the client before the court … unless: (1) the

44 ABA Rule 1.7 (a)(2). The Texas Rule (1.06) expresses the same prohibition in a slightly different manner, prohibiting the attorney from taking on a representation that “… reasonably appears to be or become adversely limited by the lawyer’s or law firm’s responsibilities to another client or to a third person or by the lawyer’s or law firm’s own interests.”

45 ABA Rule 1.10, Comment [3].

46 ABA Rule 1.7 (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; (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.”
testimony relates to an uncontested issue, (2) the testimony relates to the nature and value of legal services rendered in the case, or (3) disqualification of the lawyer would work substantial hardship on the client.\(^{47}\)

VII. “LATERAL CONFLICTS”

Interesting conflicts issues arise when a lawyer shifts from one law firm to another (i.e., a so-called “lateral hire”) – about a third of all private practice attorneys do so within the first three years of practice – and more than half do so within the first seven years.\(^{48}\) This transition between firms links the two firms, temporarily, in an often uncomfortable manner. Sure, the lateral’s old firm can simply rely on the professionalism of the attorney in question to honor all commitments to respect the confidentiality of any and all knowledge about clients and their various matters obtained while at the firm. For the “hiring firm,” though, the challenges are far greater.

A. Actual and Imputed Knowledge.

The first task of the new firm is to “pre-determine” if the arrival of the new attorney will “conflict us out of any matters we’re now handling.” That will depend on what actual knowledge the lateral attorney brings with her when she lands in the new firm. Here’s how that works.

“Imputation” (of conflicts and of knowledge) is an interesting concept. We know that any attorney working at a law firm of two or more attorneys is “deemed” to know whatever any other attorney knows in the firm concerning the legal affairs of their clients, such that if one attorney is conflicted, all are conflicted (no matter how large and far-flung the firm may be).\(^{49}\) Thus, the actual knowledge of one attorney is “imputed” to all others. Absent an “ethical screen,” if a partner in my Austin office holds information that would conflict him out of representing a particular party in a particular case, then I am also equally conflicted (although I may not actually realize it).\(^{50}\) Generally speaking, all attorneys within a firm are treated, for these purposes, as a single attorney.

Fortunately, that imputation disappears when the lateral hire departs the old firm. From the moment she walks out the door for the last time, she is no longer “deemed” to share all knowledge possessed by all attorneys at her old firm. But she also (we assume) obtained some actual knowledge of some of the clients, while working at the old firm, and their various legal affairs, including, of course, the clients she worked for directly. She cannot erase that actual knowledge by simply walking out the door. And when she lands at the new firm the next morning, every attorney at the new firm (absent an “ethical screen”) will immediately be “deemed” to share her actual knowledge from the prior firm. That is a cross-pollination of imputed knowledge that can be disastrous if not properly anticipated.

**Example:** At her old firm, your new lateral hire litigator counseled a bank client about a series of document reviews and reports that showed a critical (but not easily spotted) flaw in the perfecting of that client’s security interest in the manufacturing equipment of a large borrower at plants spread through 23 states from coast to coast. That borrower has filed for chapter 11 relief. When she arrives at your firm, everything seems normal until she stumbles upon the fact that in your San Antonio office, you have a bankruptcy partner representing the committee of unsecured creditors in that chapter 11 case. What to do? Obviously she’s not going to call the bankruptcy partner in San Antonio and describe the damning nature of the lien perfection studies – she’s way too professional to even consider doing that – but the problem is, the San Antonio partner (and every attorney on that team) is now “deemed” to know what they don’t, in fact, know. Her knowledge is “imputed to them.” If she says nothing, things may rock along as usual (although one could argue that she still has an duty to her prior client to prevent this deemed ethical breach from continuing). If she tells the firm’s conflicts czar of the problem, the firm may then realize that it may have to resign from this profitable committee representation. Worst scenario: she lets sleeping dogs lie until, two months later, the bank moves to disqualify the firm that hired their former, very knowledgeable, attorney, and seeks sanctions against the firm for not immediately resigning from the representation of the committee when the new attorney came on board. What do you do now? There are no happy answers.

B. Clearing Conflicts . . . or Poisoning Wells.

As a practical matter, and to nip these problems in the bud, the new firm (the one that is hiring the

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\(^{47}\) See, e.g., Cerros v. Steel Technologies, Inc., 398 F.3d 944, 955 (7th Cir. 2005).

\(^{48}\) After the JD: First Results of a National Study of Legal Careers, by the American Bar Foundation and the Foundation for Law Career Research and Education at the National Association for Law Placement (2004).

\(^{49}\) ABA Rule 1.10(a); National Medical Enterprises, Inc. v. Godbey, 924 S.W.2d 123 (Tex. 1996).

\(^{50}\) Texas Rule 1.09(b).
lateral) must undertake a serious investigation of any and all potentially conflicting representations and involvements of the new attorney before she arrives at the firm as an employed attorney and “imputes” her knowledge to everyone there.\footnote{This is a somewhat delicate dance, with information about their current engagements being shared with the prospective new hire, and the new hire sharing information regarding former clients and matters – all without violating ethics rules on nondisclosure of client identity and information – and all before the actual hiring is even finalized. See: ABA Formal Opinion 09-455 (Oct. 8, 2009) [Standing Committee on Ethics and Professional Responsibility] ... finding that lawyers should be permitted to disclose the basic information needed for such a conflicts analysis on a reasonable, need-to-know, non-prejudicial basis. The ABA Rules are intended to be "rules of reason." Prohibiting client list disclosures in such cases could well work against the client's own best interest by inviting "surprise conflicts" later down the road ... not to mention precluding lawyer from moving between two firms in a careful, ethically proper manner.} If and when all the facts are known, and the potential for imputed “conflicts” (arising from actually acquired confidential information about the former firm’s clients or from actual personal representation of a client at the prior firm, or both)\footnote{In re Proeducation International, Inc., 587 F.3d 296, 301 (5th Cir. 2009).} is determined to be nil, then the new employment may safely commence. When potential problems are spotted, the hiring can be made contingent upon receipt of an informed consent from the client affected. That proper consent can prevent the “poisoned well” problem from ever developing. Unhappily, this makes lateral hiring hard for everyone involved – “when it’s done right.” The lateral will naturally dislike the idea of letting the cat out of the bag about her prospective job offer (and telling the attorneys at the old firm that she needs to approach their client(s) to request consent). If she is given permission to approach the potentially conflicting clients and one refuses to give the consent, the new job offer may evaporate of necessity, and her old employer may take the whole exercise as evidence of disloyalty to the firm. Not good.

It is important to remember that we are talking here about the conflicts potential of the lateral hire’s actual knowledge and actual prior representations (questions of fact), and any presumption that the lawyer is conflicted based upon imputation of the knowledge of, and representations undertaken by, other attorneys at the prior firm may be rebutted by the lateral attorney’s testimony and other evidence (perhaps even successfully), should a dispute over disqualification later arise.\footnote{In re Proeducation International, Inc., 587 F.3d 296 (5th Cir. 2009).} However, fail to rebut the presumption (or practice outside the Fifth Circuit where you can run into courts that see the presumption as irrefutable), and the outcome can be devastating.\footnote{See, e.g., O'Donnell v. Robert Half International Inc., No. 2004-12719-NMG (D. Mass. 10 Aug. 2009).}

C. Ethical Screens.

Sometimes a client at the old firm will be more comfortable with giving an informed consent if it can strike an agreement with the new firm that a proper and effective “wall” will be constructed at the new firm (relating to the representation in question) between the lateral hire attorney and all other attorneys in the firm. This “walking off” is usually the best hope for salvaging an otherwise undoable lateral hire, but, in Texas, it cannot be undertaken “unilaterally.” The old client and the new firm must agree to the wall specifically and in writing. And, in Texas especially, the agreed screen should be set up before the imputed conflict takes effect – it’s not a great tool for “curing” a conflict that has been in place and operating for some period of time.

D. Last Ditch Measure.

If the old client refuses to consent to the lateral hire, the new firm might have one final card to play. Go (in the example above) to the bankruptcy judge in the San Antonio case, before the new lawyer comes aboard at the firm, and seek an order (after notice and hearing) establishing the grounds upon which the new attorney may accept the job offer. If the judge is convinced that the firm will establish an effective screen – even though the old bank client refuses to consent – the court’s order to establish the screen will be sufficient to permit the new hire to start working at the firm (but, naturally, never be involved with, or even discuss, the matter in question). If the court is approached only after the problematic imputation has taken place, it is possible a judge would find the equities and circumstances of the case veer away from disqualification, but such ex post facto resolutions are discretionary with the court and unpredictable.\footnote{Henderson v. Floyd, 891 S.W.2d 252 (Tex. 1995); Phoenix Founders, Inc. v. Marshall, 887 S.W.2d 831 (Tex. 1994). But see COC Services, Ltd. v. CompUSA, Inc., 2002 Tex. App. LEXIS 5687, 2002 WL 1792479 (Aug. 6, 2002) (law firm not disqualified, even though lateral hire attorney had worked on matter for an opposing party at a minimal level; equity weighed against disqualification).}
E. **Really Last Ditch Measure.**

If the firm hires the new lawyer and then discovers that a conflicts “mistake” has been made that could potentially disqualify the firm (as above illustrated) in a significant ongoing matter, there is some indication in the rules and case law that immediately discharging the new hire can help salvage the endangered representation. The ethical justification for such a measure is that the lateral hire should probably have done a much better job “coming clean” with the new firm on the clients she worked with and the matters she became familiar with.56

F. **And What About Non-Lawyer Employees of a Law Firms?**

Just because a legal assistant, secretary, paralegal, or law student (when shifting employment from one firm to another) is not a lawyer doesn’t mean they can’t generate a disqualification tempest when they arrive at the new firm. They work on cases like lawyers; they often know the clients well; they obtain large quantities of confidential client information and case strategy in the process. Heaven knows sometimes they seem to know more about the cases and clients than the lawyers they work for (I didn’t say that). So, does hiring a non-lawyer employee from another firm entail all of the conflicts checks and consents described above for attorneys?

In Texas, this is the one area where “unilateral” ethical screens can be employed to insulate the firm from the problems of lateral hire conflicts. Document, implement and continue to enforce the “wall” properly, and it seems clear that, in Texas at least, that will suffice to preclude grounds for future disqualifications.57

VIII. **“DEFENSES TO DISQUALIFICATION”**

What are some of the classic ways law firms offer to explain and exculpate themselves from the woes of conflicts disqualification?

A. **Thrust-Upon Conflicts?**

This is the “mergers and acquisitions” defense to a conflicts disqualification. The thrust of the argument, so to speak, is that “everything was going along just fine until the opposing party merged into, or otherwise acquired, controlling interest in, another client who is uninvolved in this matter, and then moved to disqualify the firm because we were ‘being adverse’ to a current client of the firm – a situation they craftily created on their own and then refused to resolve with a simple consent.” Some courts are sympathetic to this defense. The law firm charged with disqualification did nothing “wrong,” it just experienced a change of playing field caused by others. The maneuvering party was the opponent – possibly with the guilty purpose of achieving the disqualification they now seek. One of the often cited authorities for this defense is Gould decision out of the Northern District of Ohio,58 which refused to disqualify the firm, but required it to withdraw from further representing the “other client” creating the conflict and to construct an ethical screen between the attorneys handling matters for the two clients involved. Ordering such a screen seems to be a fair way to handle the matter, given its origination in the clever hands of the party moving to disqualify.

Comment [5] to ABA Rule 1.7 offers additional guidance:

> Unforeseeable developments, such as changes in corporate and other organizational affiliations or the addition or realignment of parties in litigation, might create conflicts in the midst of a representation, as when a company sued by the lawyer on behalf of one client is bought by another client represented by the lawyer in an unrelated matter. Depending on the circumstances, the lawyer may have the option to withdraw from one of

56 ABA Rule 1.10(b) (requiring the firm to demonstrate that, prior to her discharge, the attorney did not, in fact, reveal any confidential information about the case in question); *Carbo Ceramics, Inc. v. Norton-Alcoa Proppants, Inc.*, 155 F.R.D. 158 (N.D. Tex 1994).

57 *In re American Home Products Corp.*, 985 S.W.2d 68 (Tex. 1998) (holding generally that adequate screening measures would rebut the presumption that legal assistant shared confidential information with her new firm, although in this case it found that screening measures were inadequate, thus disqualified firm); *Arzate v. Hayes*, 915 S.W.2d 616 (Tex. App.-El Paso 1996, writ dism’d) (“sufficient precautions” were taken to screen legal assistant); *Phoenix Founders, Inc. v. Marshall*, 887 S.W.2d 831 (Tex. 1994); *Grant v. Thirteenth Court of Appeals*, 888 S.W.2d 466 (Tex. 1994); and Texas Opinion No. 472 (June 20, 1991) (discussion of screening for lateral secretaries and legal assistants).

the representations in order to avoid the conflict. The lawyer must seek court approval where necessary and take steps to minimize harm to the clients. ... The lawyer must continue to protect the confidences of the client from whose representation the lawyer has withdrawn.

B. Nominal Party Conflicts?

This is the defense of “form over substance.” Sometimes parties are named in an adversary proceeding only as a matter of form (e.g., a named subrogee to insurance coverage) and not as a true party in interest. Courts have held that such a party may not prevail in trying to use that constructive “client status” to disqualify the firm from becoming adverse to the “nominal party” in other matters.  

C. Accommodation Clients?

This defense to disqualification only works “some of the time.” It goes like this. Assume you represent a large bank group in a chapter 11 case, and your “real” client is Belgian National Bank, the agent bank for the credit. Belgian’s general counsel is the only voice you hear as “client” and, other than clearing conflicts at the outset, you are fairly oblivious to the names of the twenty-something banks in the bank group. Still, you represent the “bank group” by and through its agent. Later on, a lawyer with your firm files an answer on behalf of a firm client in a matter brought by Egyptian National Bank. A month later he receives a motion to disqualify, based upon the fact that Egyptian National is one of the members of your chapter 11 bank group.

So, Egyptian National is not a “nominal party” (they are a true, albeit small, member of the bank group your firm represents in the bankruptcy), and the conflict is not “thrust upon” your firm by some merger or acquisition involving Egyptian National. Your argument is that Egyptian National is simply not a true, “primary” client and certainly never shared with your firm any confidential information with the expectation that it would be treated as confidential. For some courts this is a valid argument. For others, it is unconvincing.

D. Non-Acrimonious Dealings?

This defense dredges up the often complex question of direct and material adversity. It arises when the representation in question is one in which the objectives of the two sides are fundamentally aligned – perhaps only the details of the transaction (usually) are being worked out. When there is zero acrimony, can there be direct and material conflict? If not, can you safely proceed without consent when the client you represent in the “deal” is across the table from another client of the firm (who has retained separate counsel for this transaction)?

If acrimony never arises, the conflicts potential for this scenario may never come to the surface as a practical matter. Assume in this example, however, that, after the closing, the opposing party/client suffers substantial economic loss as a consequence and sues your principal client for fraud and your firm for its breach of loyalty and for aiding the client in its nefarious scheme.

Under the Texas Rules discussed above, this positioning of the law firm is potentially permissible even without consent. In fact, the Texas Rules probably even permit one attorney to represent both sides of a transaction, concurrently, with consent.

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62 Texas Ethics Opinion 525 (Mar. 1998) (under Texas’s unique conflicts Rule 1.06, a lawyer could represent lender and seller in a real estate transaction,
For sales and other negotiations associated with an active bankruptcy case, however, the rules are less permissive absent proper consents. The ABA Rules require informed consent for any sort of direct adversity. Do not think that the client on the other side of the table from you has “effectively waived” because its representatives are aware that your firm represents them in other matters. Also bear in mind that you will need a second informed consent signed by the client sitting next to you. If subsequent events prove costly, you will want to have that consent in case the client starts communicating that one of the reasons for the negative outcome was your “continued fawning loyalty” to the opposition.

E. **Hot Potatoes?**

This defense is one that is sometimes tried, but seldom works. It means that you are defending the motion to disqualify the firm in a lucrative representation by showing the court how, before the controversy arose, your firm “fired its old client.” In other words, “Judge, after informal discussions with our new client, we dropped this old client like a hot potato. In fact, we fired them several days before we formally accepted the new representation against them … and still they’re complaining!” Numerouse opinions have rejected this defense. Other courts, however, have permitted the termination of an old client, under particular circumstances, in order to overcome a conflict of interest.

if lawyer believed the representation would not be materially affected and obtained the consent of both after full disclosure).


65 A central consideration in these cases is whether or not the “dropped” client was truly an active client “when dropped.” In other words, some clients are intermittent and sporadic in their use of a particular firm. If that firm can show that, at the time of its taking on the new representation, the “old client” had no active representations or consultations underway, filing an action against them on wholly unrelated issues probably does not present a question of “direct adversity against a current client.”

66 As always, the best practice is to keep clear documentation in your files of when an entity is, and when it is no longer, a client of the firm.

IX. **THE CONFLICTS OF ‘SWITCHING SIDES’**

This interesting little “nook” of conflicts law always bears reviewing. Attorneys are advocates who are well versed in seeing both sides of any issue in controversy. So when one client hires us to assert a particular legal claim, and another (in a different case) hires us to defend vociferously against a similar claim, we have little difficulty doing both. We are versatile.

Unless, of course, it presents a conflict of interest. But how could that be a conflict?

Fortunately, we have some guidance for addressing this kind of conflict in Comment [24] to ABA Rule 1.7, which provides: “The mere fact that advocating a legal position on behalf of one client might create precedent adverse to the interests of a client represented by the lawyer in an unrelated matter does not create a conflict of interest. A conflict of interest exists, however, if there is a significant risk that a lawyer’s action on behalf of one client will materially limit the lawyer’s effectiveness in representing another client in a


The comment goes on to state several elements that must be examined carefully when deciding whether to go forward with the divergent advocacy (and in making a determination as to the need to communicate the potential risks to the affected clients): “... where the cases are pending, whether the issue is substantive or procedural, the temporal relationship between the matters, the significance of the issue to the immediate and long-term interests of the clients involved, and the clients’ reasonable expectations in retaining the lawyer.”

The ABA Ethics Committee, in 1993, issued ABA Formal Opinion 93-377 (Oct. 16, 1003) clarifying, in case there was any doubt, that this issue comes up in trial courts as well as appellate courts, and that the ABA Rules do not permit a lessening of the lawyer’s responsibility to zealously protect the legal interests of each client involved. If the lawyer feels hampered in one argument by the negative effects its success in that case may have on another client in another case, it could well be that she should find substitute counsel to take the lead – or otherwise obtain the informed consent of each affected client before proceeding.

So the bottom line seems to be that (a) a law firm cannot concurrently represent or advance opposite positions on a legal issue before a single court, (b) otherwise, a law firm may represent and advance opposite positions on a legal issue as long as to do so does not adversely affect the legal interests of either client nor the unhampered pursuit of the legal interests of each client, and (c) some circumstances do call for the informed consent of affected clients before the firm can do (b) above.

X. ATTORNEYS FOR THE DEBTOR
In conjunction with the requirements to comply with the ABA Rules, the Texas Rules and any other applicable local rules of court concerning conflicts, bankruptcy attorneys must also comply with several other bodies of “conflicts law” contained in §§ 327 to 329 and 1103 of the Bankruptcy Code (the “Code”). In addition, the Bankruptcy Rules (like 2014, 2016, 2017, and 2019) require certain specific disclosures of possible conflicts of interest for lawyers practicing before the bankruptcy courts.

A. Prepetition Representation of Debtor
Nothing could be more understandable than a business bankruptcy debtor’s wanting its long-standing legal counsel to continue the relationship and represent it in its coming chapter 11 case. What are the considerations? Section 327 of the Bankruptcy Code (“Code”) sets the standard for retention of attorneys, accountants and other professionals by a debtor.68 Section 327(a) effectively requires that an attorney for a bankruptcy debtor or trustee: (1) not “hold or represent an interest adverse to the estate” and (2) be a “disinterested person.”69

Generally, a debtor’s lawyer “holds or represents an adverse interest” if he or she either: (1) possesses or asserts an economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or a potential dispute in which the estate would be a rival claimant, or (2) possesses or has a predisposition under the circumstances to be biased against the estate or to act differently than he or she would otherwise have acted.70 Section 101(14) of the Code defines a “disinterested person” as, inter alia, one who is not a creditor, equity security holder, insider of the debtor, or a person holding an interest materially adverse to the interest of the debtor’s estate or its creditors.

Some courts have ruled that a professional is not disinterested if that person has some interest or relationship “that would even faintly color the independence and impartial attitude required by the Bankruptcy Code and Bankruptcy Rules.”71 Interestingly, this standard has been discredited by the

69 See Sec. 1107 of the Code imposes the Sec. 327 requirements on lawyers retained or employed by a Chapter 11 debtor in possession.
71 In re Granite Partners, L.P., 219 B.R. at 33 (quoting In re BH&P, Inc., 949 F.2d 1300, 1308 (3d Cir. 1991)).
Third Circuit as an iteration of the “appearance of impropriety” test. Thus, as a general rule, counsel for the debtor (and his or her firm) must fully disclose to the bankruptcy court all prepetition compensation arrangements and all prior relationships and connections with the debtor and other relevant parties, and must not be a creditor, an equity holder, or an affiliate of the debtor.

1. Shifting from Prepetition Counsel to General Bankruptcy Counsel.

Given the requirement of disinterestedness and the full disclosure of connections, a lawyer’s prepetition employment by a debtor will not, per se, disqualify him or her from future employment as debtor’s counsel for that same client in a bankruptcy case. Under Code Section 327(a), as long as the professional fully discloses his or her previous representation, is a disinterested person, and does not hold or represent an interest adverse to the estate, such as a claim for fees, courts will likely approve such representation after notice and hearing. In fact, bankruptcy courts may even look favorably upon the same counsel transitioning from prepetition representation to bankruptcy representation (assuming that counsel is competent in bankruptcy as well), if such continued representation will increase the efficient administration of the bankruptcy case. Nevertheless, counsel may encounter new conflicts of interest issues relating to such a representation based, for example, on some debt owed to the attorney by the debtor or receipt of a pre-bankruptcy payment of invoices that could be an avoidable preference.

Under other circumstances, a lawyer or a law firm may represent a debtor prior to bankruptcy and then be retained as “special counsel” to the debtor (as opposed to general bankruptcy counsel under Section 327(a)) once the case is underway. As opposed to the more stringent standard set forth under Section 327(a), which requires that general counsel for the debtor be both a disinterested person and represent no adverse interest to the estate in general, Section 327(e) of the Code permits “special counsel” to represent the debtor for a specified special purpose, if such representation is in the best interest of the estate, and if that lawyer simply does not hold or represent any interest adverse to the debtor or to the estate with respect to the matter on which such lawyer is to be employed. Proposed special counsel to the debtor must also disclose to the bankruptcy court and general creditors any possible disqualifying adverse interests he or she may represent or hold, and must obtain court approval for the retention. It is not the intent of the Code that Section 327(e) be used as an easy way for lawyers to serve as nominal “special counsel” (thereby bypassing the disinterestedness requirement) while, in fact, acting as general bankruptcy counsel to the debtor.

2. Firm as Prepetition Creditor.

In general terms, a creditor of the debtor would not be considered a disinterested person under the Code. If a firm is a prepetition creditor of a debtor, and such position presents an actual conflict for the firm or the lawyer as debtor counsel in the bankruptcy case, then the bankruptcy court may decide not to permit the proposed representation. The main elements examined by the courts in order to make this determination are: whether the firm or law firm was owed a substantial fee for its prepetition bankruptcy work, and the nature and extent of the actual relationship, pre-bankruptcy, between the lawyers of the firm and the debtor (e.g., as an insider of the debtor). It is important that a lawyer carefully consider these and other factors in determining whether to seek employment as debtor’s counsel.

A lawyer faced with this situation should also be aware of ABA Rule 1.7(a)(2), which, as explained

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72 In re Marvel Entertainment Group, Inc., 140 F.3d 463, 477 (3d Cir. 1998) (holding that actual conflict will lead to disqualification, but potential conflict disqualification is discretionary with court, and court may not disqualify in “appearance of conflict” situations).
73 All “connections” must be disclosed, even those that have no possibility of presenting conflicts questions, and even those where informed consent has been given by the “connection” individual or entity.
76 In re Tidewater Memorial Hospital, Inc., 110 B.R. 221, 228 (Bankr. E.D. Va. 1989).
above, prohibits representation when there is a significant risk that the representation may be “materially limited” by the lawyer’s own interests or by his or her responsibilities to other clients or third persons. Conflicts of interest under ABA Rule 1.7(a)(2) are usually fact-specific and can arise in a variety of ways in bankruptcy, particularly if counsel has represented other clients affiliated with the debtor.

3. Debtor’s Counsel as Recipient of a Possible “Preference Payment.”

An attorney (or firm) who received from the debtor a payment of an allegedly avoidable preference (as defined under Section 547 of the Code) may not be permitted to represent the debtor in the bankruptcy case in which the preference may be adjudicated. This is because the potential or actual repayment of the preference would normally transform counsel into a prepetition creditor for the amount repaid (and thus a person holding a claim adverse to the estate). However, other courts have held that a law firm receiving payment of an allegedly avoidable preference from a debtor may still represent the debtor in the corresponding bankruptcy case.

If a firm is acting as prepetition legal counsel to a potential bankruptcy debtor and anticipates becoming counsel to the debtor in bankruptcy, it will likely seek to reduce or eliminate the risk of disqualification due to receipt of potentially preferential payments before the case is initiated. Some strategies employed by attorneys faced with this issue include: escrowing the allegedly preferential fee payments until later determination as to its “recoverability,” waiving their right to litigate the preference issue if later filed as an action in the case, waiving their claim to fees should a court or examiner determine payments were preferential, or requesting a retainer in advance from the client instead of accepting payments that would be clearly preferential—and waiving any right to collect the unpaid sums in the bankruptcy case. Lawyers should proceed cautiously and, above all, accurately disclose the pertinent facts in order to avoid the risk of possible sanctions, including disqualification.

B. Current or Previous Representation of Other Parties in Interest.

Although rarely seen, as a practical matter, it is clear from the language of Section 327(c) that an attorney is not disqualified as debtor’s counsel solely because of that attorney’s prior or current representation of another party in interest in the case. However, a lawyer who desires to act as general bankruptcy counsel to a debtor and to represent a creditor in that same proceeding remains subject to the provisions of Code § 327(a) [requiring that the attorney not hold or represent any interest adverse to the estate, and is a disinterested person]. Section 327(c), as amended in 1984, was apparently intended to allow concurrent representation of a creditor and a debtor only where the dual representation is the lone reason advanced for disqualification and there is no apparent conflict of interest resulting from the representation. If an objection to such employment is made by another party in interest in the case, or by the United States Trustee, the bankruptcy court will disapprove the employment if it concludes that an actual conflict of interest exists (e.g., where the attorney is actively representing the creditor in a claim against the estate, or is defending the creditor from claims filed against it by the estate), and may

79 In re Pillowtex, 304 F.3d 246, 253 n.5 (3d Cir. 2002) and In re First Jersey Securities, Inc., 180 F.3d 504, 509 (3d Cir. 1999).
80 See In re Decor Corp., 171 B.R. 277, 282 (Bankr. S.D. Ohio 1994) (allowing a law firm that received payments from the debtor within the 90-day period prior to the filing of the bankruptcy petition to represent the debtor in that proceeding, provided the law firm performed curative measures, including the return of all such payments to the debtor) and In re Creative Restaurant Management, Inc., 139 B.R. 902, 915 (Bankr. W.D. Mo. 1992) (the fact that a law firm represented the debtors prior to the filing of their Chapter 11 cases and was paid for such representation does not make firm ineligible to continue its representation after the filing of the Chapter 11 case; it simply means that the bankruptcy court has the authority to review any compensation received by the law firm within one year of the filing of the bankruptcy cases).
82 11 U.S.C. § 327(c)(“… a person is not disqualified for employment under this section solely because of such person’s employment by, or representation of, a creditor …”).
83 In re Interwest Business Equipment, Inc., 23 F.3d 311, 316 (10th Cir. 1994).
disapprove the employment if it determines that a potential conflict is present.\textsuperscript{84}

Courts attach different meanings to the term “potential conflict of interest.” A number of opinions use the term “potential conflict” to describe a situation that is not an ethical violation, in contrast to an “actual conflict” that is an ethical violation.\textsuperscript{85} In any event, something more than merely concurrent representations must be shown to disqualify counsel from undertaking the representation scenario.

Another sensitive (and problematic) combination of representations is the concurrent representation of the bankruptcy debtor and the affiliates or principals of the debtor entity, such as its owner(s), chief executive officers, directors, etc. While not, \textit{per se}, requiring disqualification,\textsuperscript{86} many courts do find this relationship to be rich with the prospects of conflict (or at least a lack of disinterestedness).\textsuperscript{87}

Section 327(c) is admittedly capable of different interpretations. Just how far an attorney (for the debtor) can go in “concurrently representing” a creditor in the case without running headlong into a direct conflict of interest (prohibited by Section 327(a)) is a matter of some speculation. Perhaps there is no direct or material adversity between debtor and creditor; perhaps they both happily agree that a particular amount is owed and should be treated as such in the case without controversy (i.e., a claim that is scheduled without being termed “disputed, contingent, or unliquidated”). If the two parties are substantially aligned on the validity and amount of the

\begin{itemize}
  \item \textsuperscript{84} 11 U.S.C. § 327(c); \textit{In re Zenith Electronics Corp.,} [241 B.R. 92, 101 (Bankr. D. Del. 1999)]; and \textit{In re Intermart Business Equipment,} [23 F.3d at 316].
  \item \textsuperscript{87} \textit{In re Wynne Residential Asset Mgmt., LLC,} [2009 Bankr. LEXIS 4164 (Bankr. W.D.N.C. December 18, 2009)]
\end{itemize}
information in ABA Rule 1.9(c) are not limited to cases in which the prospective representation is in the same or a substantially related matter.

Bankruptcy courts can and do apply state rules of professional conduct. In 2006 the bankruptcy court in Delaware applied the Delaware Rules of Professional Conduct to disqualify a prominent firm from a significant engagement.91 Prior to the bankruptcy, on behalf of Stanfield Capital Partners, the firm analyzed credit agreements related to Meridian and its affiliates, secured in part by a first lien and in part by a second lien, including an intercreditor agreement between the first and second lenders. After Meridian filed for bankruptcy, an informal committee of first-lien-only creditors hired the firm to assist in the bankruptcy. The court disqualified the firm under Delaware Rule 1.9. The law firm conceded that the interests of Stanfield and the informal committee were adverse, but argued that the two matters were not the same or substantially related. The bankruptcy court disagreed, finding that the matters were the same and that the firm was essentially changing sides.

C. Attorney as Officer, Director, or Equity Holder of Debtor Prior to Bankruptcy

“Insider status” of an attorney will, at minimum, trigger extra scrutiny in the employment of debtor’s counsel. Section 101(31) generally defines an “insider” as a relative or partner of an individual debtor or a partnership in which the debtor is involved; a director, officer, or controlling person of a debtor corporation or a partnership in which the debtor is a general partner; and the general partner, relative of the general partner, or person in control of a debtor partnership, or a partnership in which the debtor is a general partner. An insider also includes an affiliate of the debtor and the insiders of that affiliate.

An attorney’s valiant service as an officer or director of a prepetition debtor renders that firm not “disinterested” with respect to representing the debtor, even if the attorney resigns as director when the firm is retained to become debtor counsel.92 In most cases, this lack of disinterestedness will preclude a firm from representing the debtor. Even serving as secretary to the corporate debtor can require disqualification of the attorney and law firm as debtor’s bankruptcy counsel.93 Bankruptcy counsel’s act of becoming an officer of the debtor corporation during bankruptcy can have the same disqualifying consequence as pre-bankruptcy service.94

What about “attorney as stock holder?” Although an equity security holder is generally not an “insider” under the Code, he or she is still not a disinterested person.95 However, as a practical matter, some bankruptcy courts will allow lawyers or other professionals to represent the debtor despite a small number of shares of the publicly traded debtor being held by firm members.96 Other courts require disqualification despite a firm lawyer’s ownership of only a small percentage of the outstanding equity shares of the debtor.97 Best Practice: In connection with the firm’s proposed retention as debtor’s counsel, attorneys should, at minimum, disclose any ownership of equity securities of a debtor.

D. Multiple-Debtor Representation

There is no per se conflict of interest in one debtor’s counsel firm representing two or more debtor entities in a consolidated case.98 Rather, courts typically examine the unique facts of the case and make a determination of appropriateness.99 Factors that the bankruptcy court will consider in determining whether such joint representation is permissible

94 In re Weaver Potato Chip Co., 243 B.R. 737 (Bankr. D. Neb. 2000) (by attempting to become president of the debtor corporation, bankruptcy counsel, who was also a creditor, became an “insider” as defined in 11 U.S.C. § 101(31)).
98 In re Andura Corp., 121 B.R. 862, 871 (Bankr. D. Colo. 1990) (no per se rule against representing parent and subsidiary debtors).
99 See In re BH&P, Inc., 349 F.3d 1300, 1310 (3d Cir. 1991) and In re Pillowtex, Inc., 304 F.3d 246 (3d Cir. 2002).
include the nature of disclosure of any conflict made at the time of appointment; whether interests of related estates are parallel or conflicting; and the nature of any inter-debtor claims (e.g., shared guaranty liability, intercompany payables). Often the bankruptcy court decides that the most effective (i.e., least time-consuming and costly) way to administer related-debtor cases is to permit the use of a single firm.

Some case law focuses on the potential existence of conflicts of interest in disqualifying counsel from representing multiple related debtors based on a strict construction of Sections 327, 328(c), and 1107(b) of the Code. Other decisions have disqualified attorneys representing affiliated entities based on actual conflicts of interest. Some have required a showing of an actual conflict before disqualifying joint counsel. In the cases where the courts have declined to disqualify, the opinions seem to take the practical approach that, absent actual adversity, the economic advantages and increased efficiency gained through joint administration of the multiple-debtors estates justifies continued employment of counsel. Finally, some courts have held that concurrent representation of affiliated or related debtors results in a rebuttable presumption that the representation is per se improper.

Beyond the provisions of the Code and Rules, it must be remembered that ABA Rules 1.7 and 1.9 generally set forth standards that apply to the representation of multiple debtors in a bankruptcy case. Clearly, the ABA Rules prohibit a lawyer’s representation of one client in a matter that is directly or materially adverse to the lawyer’s representation of another current or former client or that has a significant risk of being materially limited by the lawyer’s responsibilities to her new client, another current or former client, or a third person, or to her own interests, unless she reasonably believes that she will be able to provide competent and diligent representation of each affected client and obtains informed client consent, confirmed in writing. In that case, assuming bankruptcy court approval has been obtained, representation of multiple debtors may go forward. Nonetheless, some courts have held that a Chapter 11 debtor in possession cannot consent to representation in this context absent notice, and in some cases, the consent of affected creditors.

Although state rules of professional conduct apply generally to the determination of whether a lawyer is disqualified from undertaking representation of multiple clients in a bankruptcy matter, at least one bankruptcy court has recognized “that activities and multiple representation that may be acceptable in commercial settings, particularly with the informed consent of clients, may not be acceptable in bankruptcy.”

E. Debtor Attorney’s Duty of Loyalty

An attorney retained by a debtor entity must also be aware that she represents the entity and not its shareholders, officers, or directors. A number of bankruptcy courts have disqualified counsel for a Chapter 11 debtor on the grounds that the attorney was actually representing the interests of the debtor’s management or other insiders and not the debtor per se. These cases involve situations where the insider at issue is involved in its own bankruptcy case and where the insider is not a debtor or debtor in possession.

100 See, e.g., In re W.F. Development Corp., 905 F.2d 883 (5th Cir. 1990) (lawyer disqualified from representing both limited partners and general partner in bankruptcy because possibility for conflict always present) and In re Al Gelato Continental Desserts, Inc., 99 B.R. 404 (Bankr. N.D. Ill. 1989) (law firm disqualified from representing three debtors in a Chapter 11 case where one debtor was an officer of the second debtor and a stockholder, officer, and the largest unsecured creditor of the third debtor even though lawyer asserted no actual conflict was present).

101 See In re Interwest Business Equipment, Inc., 23 F.3d 311 (10th Cir. 1994) (court denied employment of lawyer as counsel for four related debtors where one debtor controlled and held ownership interests in others) and In re First Ambulance Center of Tennessee, Inc., 181 B.R. 323 (Bankr. M.D. Tenn. 1995) (court in Chapter 11 case disallowed employment of lawyer who also represented debtor corporation’s two shareholders and directors in their individual Chapter 13 proceedings and one shareholder/director was creditor of debtor corporation).


106 See, e.g., In re Occidental Financial Group, Inc., 40 F.3d 1059 (9th Cir. 1994); In re W.F. Development Corp., 905 F.2d 883 (5th Cir. 1990); In re Westwood Homes, Inc., 157 B.R. 182 (Bankr. D. Me. 1993); In re Churchfield
The issue of an attorney’s representation of an organization is addressed in ABA Rule 1.13. Paragraph (a) of that rule states that a lawyer employed or retained by an organization represents the organization acting through its duly authorized representatives (e.g., CEO, President, General Counsel). Paragraph (f) requires that, in dealing with the organization’s directors, officers, employees, members, shareholders, or other constituents, a lawyer should explain the identity of his client if he knows or reasonably should know that the organization’s interests are adverse to the constituents with whom the lawyer is dealing. Finally, paragraph (g) allows a lawyer to represent concurrently the entity and its constituent(s), provided the lawyer complies with ABA Rule 1.7 for determining the potential for conflicts of interest—and securing consent by affected clients to the dual representation. So, attorneys must be sensitive to this three-tier structure of governance when seeking to represent a debtor and a constituent of the debtor in a Texas bankruptcy proceeding: the Code (e.g., Sections 327, 328, and 1107), the ABA Rules, and the Texas Rules.

F. Third-Party Payment of Debtor’s Counsel Fees

ABA Rule 1.8(f) expressly allows payment of fees by third party “non-clients” provided: (1) the client gives informed consent for the payment arrangement; (2) the payment arrangement does not interfere with the lawyer’s independent professional judgment or with the lawyer-client relationship; and (3) the lawyer protects, even from the “payer,” information relating to representation of the client. Lawyers may receive payments from a variety of third-party sources, including insurance carriers, prepaid legal plans, and the principals of the debtor.

Third-party payment of debtor’s legal fees is also subject to scrutiny under the lack of adverse interest and disinterestedness standards of Section 327 of the Code, as well as the disclosure requirements of Section 329 of the Code and Bankruptcy Rules 2014, 2016, and 2017. Several courts have recognized that, under Section 327, an adverse interest may be present when a debtor’s counsel receives payment of fees from a third party because of that arrangement’s potential for influencing the attorney to further the interest of the third-party payer, at the expense of the lawyer’s duty of loyalty to the debtor client.107

When the “third-party payment” issues have been presented to the courts, the rulings have varied widely. Some courts have allowed partners or shareholders of the debtor to individually pay or guarantee fees of the debtor’s bankruptcy counsel, even when the payer was also one of the debtor’s creditors.108

A recent decision out of the Eastern District of Virginia recognized “adversity” as being present when a creditor was paying the attorney’s fees for the debtor, but concluding that the facts of the case presented no “material” adversity and overruled a motion to disqualify and deny compensation as follows:

“… [under Section 327(c)] the interest that is adverse must be ‘materially adverse.’ Congress clearly anticipated the possibility of there being some adversity. Congress clearly felt that not every adversity was a disqualification. The adversity must be material ... [Citing In Huntmar Beaumeade, and In re Palumbo ] … In this case, the court is satisfied that any adverse interest between the parties who provided the retainer is not material. They do not have any effective manner in which to control the debtor or counsel in the discharge of their duties.”109


Other courts have terminated representation by debtor’s counsel where motives of a third-party payer are suspect due to its creditor status or other relationships with the debtor.110 Still other courts have ruled that any fee payment by a third party to debtor’s counsel is an actual, disqualifying conflict of interest, absent a showing that the interests of the third party and the bankruptcy estate are identical, and upon notice to all parties in interest.111 Thus, lawyers wishing to represent a debtor in a bankruptcy case, who are contemplating a third-party fee arrangement, should consider the facts and circumstances of the payment arrangement, including the relationship of the payer to the debtor, as well as how a court may view the payer’s potential motivation in paying the debtor’s fees. Court approval should be requested at the beginning of the case.

As a practical matter, any attorney seeking approval of a third-party payment arrangement would be well advised to discuss it first with the Office of the United States Trustee and attempt to develop an alternative fee arrangement that could be included in the application to the bankruptcy court. Section 329 of the Code and Bankruptcy Rules 2014, 2016, and 2017 would also require the attorney to provide notice of the proposed arrangement to the parties in interest in the bankruptcy case. If the bankruptcy court is one that rejects the notion of third-party payment arrangements, it would be better to find that out early in the case and then shift to some other form of payment rather than suffer a flat denial fees at the end of the case.

XI. ATTORNEYS FOR CREDITORS

A. Representation of Other Parties in Interest Before and During the Bankruptcy Case

Obligations to former or current clients can present conflicts precluding representation of creditors. A secured creditor will, under certain circumstances, be “directly adverse” to both general unsecured creditors (including a Chapter 11 creditors’ committee) and the debtor. General unsecured creditors will normally be adverse to the debtor and may also be adverse to each other.

As discussed above, and although rarely seen in practice, the 1984 amendments to the Code removed the prior “automatic” disqualification of firms that represent a bankruptcy trustee or debtor from representation of creditors in the same case. 11 U.S.C. § 327(c). Thus, this former or current representation of a creditor should not be enough, by itself, to bar counsel from representing a debtor and/or another creditor in the same bankruptcy case so long as there is no adversity between the parties.112 But if direct and material adversity enters the picture, the actual conflict of interest could prevent the representation.

B. Representation of Multiple Creditors in the Same Bankruptcy Case

Generally speaking, simultaneous representation of a secured creditor and one or more unsecured creditors in a bankruptcy case is permissible under the Code and Rules, provided the representation creates no actual conflicts of interest. Whether such conflicts exist depends on the circumstances of each case.113 Actual or possible future conflicts of interest may arise also among multiple unsecured creditors or between a statutorily-appointed creditors’ committee and one or more unsecured creditors during a bankruptcy case. However, as is the case with representation of both secured and unsecured creditors, representation of multiple unsecured creditors in the same bankruptcy case is permissible so long as actual conflict of interest is absent.

Attorneys in a bankruptcy case wishing to represent multiple creditors, or a creditors’ committee and one or more creditors, will be subject to applicable state rules of professional conduct relating to conflicts of interest and consent to directly adverse representations as well as (in the bankruptcy courts of Texas) applicable ABA Rules. ABA Rule 1.7(a) would require a lawyer or firm seeking to represent multiple creditors in the same bankruptcy case to assess whether the representation of one creditor client

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will be directly adverse to the representation of another such client – or whether there is a significant risk that the lawyer’s representation of any one (or more) of the such clients would present material limitations by virtue of the lawyer’s responsibilities to other clients. Nonetheless, the informed written consent exception would still apply, and the representation would be permissible under ABA Rule 1.7(b) if the lawyer …

(1) reasonably believes that he or she will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the direct assertion of a claim (or objection to a claim) by one client against another of the lawyer’s clients in the same matter; and

(4) the lawyer obtains informed consent from each affected client, confirmed in writing.

In addition, a firm or lawyer wishing to represent concurrently one or more creditors and a creditors’ committee in the same bankruptcy case must comply with the requirements of Code Section 1103(b), which provides that a professional may not, while employed by a creditors’ committee, represent another entity having an adverse interest in connection with the case. In addition, proposed committee counsel must be approved by the bankruptcy court after providing parties in interest in the bankruptcy case (including the United States Trustee) with an opportunity to object.

Section 1103(b) of the Code sets out a somewhat different standard for committee counsel than the standard for employment of counsel for the debtor stated under Section 327(a) (which mandates that a debtor may employ counsel that does not hold or represent an interest that is adverse to the estate and is a disinterested person), because Section 1103(b) contains no requirement of disinterestedness. Despite the explicit omission of a disinterestedness requirement for committee counsel under Section 1103(b), at least one court has applied the “disinterestedness” requirement of Section 327(a) of the Code to the retention of proposed attorney for a creditors’ committee. 114

If an attorney represents one or more creditors, but does not represent a creditors’ committee, then the firm or lawyer is not subject to the requirements of Section 1103(b) of the Code with respect to those representations. In fact, absent a disqualification motion based on an alleged violation of the rules of professional conduct, and apart from the requirement under Bankruptcy Rule 2019 to disclose representation of multiple creditors, retention of counsel by these creditors is generally outside the realm of the bankruptcy law.

Even though, in theory, it is possible for an attorney to represent both a secured creditor and the creditors’ committee concurrently in a bankruptcy case (and still be in compliance with the requirements under both Code Section 1103(b) and ABA Rule 1.7(a)), such representations occur rarely in practice for reasons that are fairly obvious. The reality is that such creditors are likely to be adverse to each other in the case, and a bankruptcy court is unlikely to approve the employment of a lawyer to represent both parties. Representation of a creditors’ committee and other unsecured creditors is also likely to cause actual conflicts and is not a common occurrence in practice. Thus, to avoid the possibility of malpractice claims and sanctions, including disqualification, or denial or disgorgement of fees, attorneys wishing to represent multiple creditors or a creditors’ committee and other creditors in the same bankruptcy case must comply with all requirements regarding conflicts of interest.

C. The Disclosure Prerequisite.

An attorney seeking court approval to be retained as counsel to a trustee, debtor, or a creditors’ committee must comply with the disclosure provisions of Bankruptcy Rule 2014, which requires that any professional must disclose all his or her business or personal “connections” 115 with the debtor, any of its creditors, any other party in interest in the bankruptcy, the respective lawyer(s) and accountant(s) for each of these categories, the United States Trustee, or any person employed in the office of the United States Trustee.

Even though most opinions involving compliance with Bankruptcy Rule 2014 focus primarily on the issue of disclosure of connections or conflicts, the rule


also requires the professional to disclose the reason the attorney or firm was selected to provide the proposed representation and a description of the professional services to be rendered. The duty of the professional submitting an application to be retained by the debtor or a creditors’ committee is one of complete disclosure of all facts relevant to the questions of conflicts, disinterestedness (in the case of a professional applying to represent the debtor), and adverse interests with respect to the proposed representation, as well as an explanation as to why the professional believes he or she is not adverse to the party it proposes to represent in the bankruptcy proceeding.

Bankruptcy Rule 2019 generally sets forth disclosure requirements for every entity or committee that represents more than one creditor or equity holder in a bankruptcy case. Although this rule specifically excludes a creditors’ committee from its disclosure requirements, it appears applicable to counsel simultaneously representing the committee and another creditor or creditors (whether secured or unsecured). Rule 2019 requires that each affected firm or lawyer file a verified statement identifying each creditor client, the nature and amount of their claims or interests, the pertinent facts and circumstances of counsel’s employment, and other relevant details. Any material changes discovered during the case are to be disclosed in supplemental statements.

Rule 2019 was promulgated “to prevent improper participation in a reorganization case by attorneys representing creditors and stockholders.” Although the failure to comply with the requirements of Rule 2019 could result in the loss of a lawyer’s opportunity to be heard (or, in some cases, compensated) in the bankruptcy proceeding, the rule provides the bankruptcy court with some discretion in enforcement. The court may make the denial of participation in the case final if the representative sanctioned under Bankruptcy Rule 2019(b) acted willfully in failing to comply. If such failure was inadvertent or based on a technicality, then the court may require corrective action by the representative before it may resume participation in the case.

In any event, the seemingly administrative nature of Rule 2019 should not lull the attorney into taking its requirements casually. The rule empowers the courts to strike a pleading or proof of claim as having been filed “without authority” (rendering it an invalid filing) when the attorney signing the filing is representing two or more individual entities before the court without having first filed the appropriate Rule 2019 statement with the clerk of the court. What if the stricken filing is, for example, a proof of claim filed on behalf of three individual state court plaintiffs against the debtor/defendant. If the “joint” proof of claim is filed prior to the filing of the Rule 2019 disclosure with the court, and the claims “bar date” then runs in the case, the court’s approval of a subsequent motion to strike the claim as invalid under Rule 2019 would be a real potential, which, combined with the court’s discretionary refusal to extend the bar date to permit valid post-bar-date filings by the individual creditors, could be devastating to those creditors and to their asleep-at-the-wheel attorney.

D. Consent: When Required and How Obtained.

An attorney seeking to represent a client in a matter that may pose a possible or actual conflict of interest may be required by applicable ethics rules to obtain consent in advance for the representation from each affected client. This assumes, of course, that the conflict is one that does not disqualify the lawyer or firm under the Code and is “consentable” under the rules of professional conduct.

“Informed consent” is defined by ABA Rule 1.0(e) as an “agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct.” It is clearly the best practice for any attorney seeking to be retained by two or more clients in a single case to obtain such consents, as well as complying with other applicable provisions of the Code and the Bankruptcy Rules regarding possible conflicts of interest.

If a conflict of interest is not present at the beginning of the representation but arises later, supplemental filing to correct certain discrepancies in Rule 2019 statement filed by counsel for debtor’s equity holders).


118 In re CF Holding Corp./Colt’s Manufacturing Co., Inc., 145 B.R. 124 (Bankr. D. Conn. 1992) (court required a
Conflicts of Interest in Bankruptcy Practice

In view of the wide spectrum of discretionary rulings by the bankruptcy courts in response to conflicts of interest in their cases, all law firms should have procedures in place for identifying, disclosing, and updating conflicts data in all bankruptcy matters. Careful preparation and candid documentation in initial disclosures, and implementation of routine procedures for periodic updates of disclosures, are likely to minimize avoidable conflicts problems.

A. Disqualification

Disqualification of counsel is a frequent consequence for failing to adequately disclose conflicts, “interestedness,” or an adverse interest with respect to the court-approved representation. The court may disqualify counsel from representing the debtor or a creditors’ committee based upon an objective standard, evaluating the facts of each case, regardless of the integrity or intent of the lawyer. Factors that may subject debtor’s counsel to disqualification include failure to maintain disinterestedness under Section 327(a) of the Code. In addition, disqualification of either a lawyer for a debtor or for a creditors’ committee can occur for simultaneous representation of a client having an adverse interest to the debtor or the creditors’ committee at any time after the acceptance of the representation. Finally, the same grounds may cause the bankruptcy court to deny the application of the lawyer seeking to represent the debtor or a creditors’ committee.

The disqualification of a single lawyer in a firm may be imputed to the entire firm if the court finds such imputation appropriate. The basis for this imputation is ABA Rule 1.10(a), which provides that no lawyer in a firm shall represent a client when the lawyer knows that another lawyer of the firm would be prohibited from undertaking such representation under ABA Rules 1.7 or 1.9 (relating to conflicts of interest). However, some recent decisions have declined to impute disqualification of a single lawyer


disclosure should be made to, and informed consent should be obtained from, each affected client. Even those cases recognizing the so-called “thrust upon” doctrine for conflicts arising midstream in a representation (as discussed earlier, a conflict thrust upon an attorney already engaged in representation; for example, by virtue of a corporate merger or acquisition) contemplate that the lawyer will first seek consent from the affected clients.

Of course, there are some situations where, as a matter of bankruptcy law, an actual conflict cannot be cured simply by obtaining consent to the representation by all affected clients. As a general rule, in cases involving attorneys for a debtor or creditors’ committee, the bankruptcy court may not approve continued retention in the face of an actual conflict of interest, even if the clients directly affected by the conflict have consented in writing to representation under the circumstances.

XII. FAILING TO RESOLVE CONFLICTS

Attorneys who fail to meet the standards of disinterestedness and lack of adversity or who make inadequate disclosures “may be penalized in a variety of ways, including disqualification or removal from the case, total or partial denial of compensation, or disgorgement of fees and expenses.” Section 328(c) of the Code authorizes the presiding bankruptcy court to deny compensation for services and reimbursement of expenses for a lawyer who, at any time during the lawyer’s employment, is not disinterested or represents or holds an adverse interest with respect to the matter on which the lawyer is employed. Bankruptcy Rule 2014 and the related Code sections also authorize broad sanctions for noncompliance. In addition, sanctions under applicable state ethics rules may include public reprimand, suspension from practice, and disbarment. Finally, a few cases have resulted in criminal indictments for egregious failures to adequately disclose.

121 See In re Essential Therapeutics Inc., 295 B.R. 203 (Bankr. D. Del. 2003) (establishment of “ethical wall” insufficient to avoid disqualification of a firm that had one member lawyer previously serve as an officer of the debtor for which firm sought representation).

122 In re El San Juan Hotel Corp., 239 B.R. 635, 647 (B.A.P. 1st Cir. 1999) and In re Leslie Fay Companies, Inc., 175 B.R. 525, 538 (Bankr. S.D.N.Y. 1994).

123 See In re Essential Therapeutics Inc., 295 B.R. 203 (Bankr. D. Del. 2003) (establishment of “ethical wall” insufficient to avoid disqualification of a firm that had one member lawyer previously serve as an officer of the debtor for which firm sought representation).

124 In re El San Juan Hotel Corp., 239 B.R. 635, 647 (B.A.P. 1st Cir. 1999).

to the entire firm if the lawyer was deemed not disinterested for reasons such as prior service as an officer or director of the debtor. At least one court has also allowed representation of a debtor client by a firm using an “ethical screen” to separate a lawyer who advised the debtor prepetition.

B. Disgorgement of Fees

The Code specifically authorizes, but does not require, courts to deny compensation and/or reimbursement of expenses, or require disgorgement of such fees and expense reimbursements, if at any time during retention a court-approved attorney is not disinterested, or if at any time during retention by the debtor or by a creditors’ committee the attorney holds or represents an interest adverse to the estate or to the creditors’ committee in connection with the bankruptcy case.

The imposition of disgorgement of fees is left to the sound discretion of the bankruptcy court as it reviews, addresses and imposes penalties in connection with conflicts of interest in bankruptcy. Various factors may be relevant to the court’s decision, including the severity of the violation and the degree of injury or prejudice to the estate or the creditors’ committee.

Although disgorgement often is imposed for inadequate disclosure of conflicts, bankruptcy courts also have discretion to order disgorgement or denial of fees where inadequate disclosure is not involved.

C. Disciplinary Action under State Law

Failure to comply with relevant state ethics rules can lead to attorney sanctions. Penalties for failing to address conflicts issues could include private or public reprimand, suspension from practice, or disbarment.

D. Damages

Conflicts of interest are often raised in malpractice claims litigation, and the mere presence of these issues increases the difficulty of defending the claim and often increases civil damage verdicts.

E. Criminal Sanctions

In addition to the sanctions listed above, in an extreme case, a lawyer or other professional representing conflicting parties in a bankruptcy matter may be subject to criminal sanctions.

126 See, e.g., In re S.S. Retail Stores Corp., 211 B.R. 699 (B.A.P. 9th Cir. 1997); In re Keravision, Inc., 273 B.R. 614 (N.D. Cal. 2002); and In re Capen Wholesale, Inc. 184 B.R. 547 (N.D. Ill. 1995).


128 11 U.S.C. § 328(c); Gray v English, 30 F.3d 1319, 1324 (10th Cir. 1994) (permmissive “may deny” language does not require court to deny legal fees or disgorge previously paid fees in all cases); and In re Granite Partners, L.P., 219 B.R. 22, 41 (Bankr. S.D.N.Y. 1998) (Section 328(c) authorizes but does not mandate denial of all fees; statute is permissive and denial committed to court’s discretion); see also In re West Delta Oil Co., Inc., 432 F.3d 347 (5th Cir. 2005); In re eToys, Inc., 331 B.R. 176 (Bankr. D. Del. 2005); and In re Jore Corp., 298 B.R. 703, 726 (Bankr. D. Mont. 2003) (negligent or inadvertent as well as willful failure to disclose conflicts may result in denial of all fees).


130 See, e.g., In re Howell, 148 B.R. 269 (Bankr. S.D. Tex. 1992) (counsel required evidence of actual adversity before disqualifying counsel concurrently representing multiple debtors in single case; deemed a flexible approach to economic and efficient estate administration, especially if full disclosure made initially).

131 See In re Grieb Printing Co., Inc., 297 B.R. 82, 85-86 (Bankr. W.D. Ky. 2003) (bankruptcy court determined that lawyer who inadvertently acted as both trustee and trustee’s counsel in the debtor’s Chapter 7 case and represented a creditor in another bankruptcy case where the Chapter 7 debtor was also creditor, engaged in conflict of interest justifying at least a partial denial of compensation to lawyer in his capacity as Chapter 7 trustee and counsel to the Chapter 7 trustee).

132 See, e.g., People v. Mills, 923 P.2d 116 (Colo. 1996) (en banc) (lawyer faced suspension from practice for, inter alia, failure to make appropriate disclosures regarding receipt of prepetition legal fees and to obtain bankruptcy court approval of those fees) and In re Carlton House of Brockton, Inc., 1996 Bankr. LEXIS 170, 1996 WL 442734 (Bankr. D. Mass. Feb. 20, 1996) (counsel for creditors’ committee suspended from practice before bankruptcy court pursuant to Bankruptcy Rule 9011(c) for failure to disclose to bankruptcy court and other parties in interest that he had represented, in the same case, parties with adverse interests to debtor and unsecured creditors).

133 See United States v. Gellene, 182 F.3d 578 (7th Cir. 1999).
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