2018

Conflicts Counsel is Not a Cure All; It Does Not Overcome an Actual Conflict of Interest

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2018 Volume X No. 15

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Cite as: *Conflicts Counsel is Not a Cure All; It Does Not Overcome an Actual Conflict of Interest*, 10 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 15 (2018).

Introduction

The Sixth Amendment of the Constitution guarantees the right to assistance of counsel.[1] With this right comes many nuances, including the right of an individual to obtain counsel of his or her choice in civil matters if they choose to engage in such matters. The lawyer-client relationship is a fiduciary one and it carries many responsibilities on the attorney's part. For example, a lawyer must provide "undivided loyalty" to his or her clients.[2] This means that a lawyer must be aware of any conflicts of interest that may arise in the ordinary course of business.[3] Lawyers must take the necessary steps to disclose, minimize, and/or eliminate such conflicts.

Conflicts of interest and the employment of professional persons in the bankruptcy context are governed under section 327 of the Bankruptcy Code.[4] The general rule for a lawyer as a party's general counsel in an action is that they must not hold an interest adverse to the

[1] U.S. CONST. amend. XI.
[2] MODEL RULES OF PROF'L CONDUCT r. 1.7 (AM. BAR ASS'N 1980).
[3] *See id.*
[4] *See* 11 U.S.C. § 327 (2012).

estate and they must be a disinterested person.[5] There are exceptions to the rule, such as representations involving potential conflicts of interest and the use of independent conflicts counsel to overcome such conflicts. These determinations are often made on a case by case basis.

Recently, in *In re WM Distribution,* a bankruptcy court in New Mexico held that a firm was unable to represent two related debtors in a Chapter 11 bankruptcy proceeding because: (1) the two debtor companies had a close working relationship, and (2) although the debtor companies were not mutually owned, the majority shareholders of each company were on opposite sides of a couple going through a divorce.[6] The court held that the entanglement of these two companies were so severe that there were numerous actual conflicts of interest present requiring the disqualification of counsel from representing both parties in the action.[7] Furthermore, the court held that the use of conflicts counsel was not an appropriate remedy for these conflicts because the adverse interests involved were "central to their respective reorganization efforts."[8]

Bankruptcy is a valuable method of relief for debtors, especially for debtors such as business' that wish to reorganize and continue on with their companies. But with bankruptcy proceedings comes litigation costs.[9] Such costs only add on to the debts of the parties filing.[10] Because the court is aware of such problems, often times the court will utilize methods to decrease these costs.[11] One such method is the use of independent conflicts counsel.[12] In order to

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[5] *See* 11 U.S.C. § 327(a).
[6] *See In re* WM Distribution, 571 B.R. 866 (Bankr. D.N.M 2017).
[7] *See id.* at 874.
[8] *Id.*
[9] *See* Ronald D. Rotunda, *Resolving Clients Conflicts by Hiring "Conflicts Counsel",* 62 HASTINGS L. J. 677, 697 (2011).
[10] *See id.*
[11] *See id.*
[12] *Id.*

utilize the use of conflicts counsel, the question becomes: (1) when does a conflict of interest disqualify a law firm and its attorneys from representing a client, and (2) when does independent conflicts counsel become an available method to avoid such conflicts?

This memorandum will explore the present question in a threefold approach. Part I discusses the requirements of an attorney to be employed as a professional person under 11 U.S.C. § 327(a) and what qualifies as a "conflict of interest." Part II analyzes the commonly used exception to this rule under 11 U.S.C. § 327(c). Part III concludes by analyzing the use of conflicts counsel and discussing situations in which its use is not a viable solution for such conflicts.

I. Counsel must hold no adverse interest and be disinterested to be employed as a Debtor's professional.

Under section 327(a) of the Bankruptcy Code, the court "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."[13] This statute lays out two general requirements that an attorney must meet in order to represent a party in a bankruptcy proceeding as its general counsel. *First*, they must not hold or represent an interest adverse to the estate. *Second*, they must be a disinterested person.

"These statutory requirements–disinterestedness and no interest adverse to the estate–serve the important policy of ensuring that all professionals appointed pursuant to section 327(a) tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities."[14] The purpose of these requirements is to ensure effective assistance of counsel. An attorney must be able to offer candid advice to his or her client, they must have

[13] 11 U.S.C § 327(a).
[14] Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir. 1994).

his or her client's best interest in mind at all times, and they must remain wholly loyal to his or her client above all other parties.[15] These fiduciary obligations are not possible when a conflict of interest is present.

There are two main categories of conflicts of interests: actual conflicts of interest and potential conflicts of interest.[16] A potential conflict of interest is not a conflict that exists at the current time of the action; however, there is a possibility that a conflict may emerge during the course of the litigation.[17] Although defined by the Model Rules, the Bankruptcy Code itself does not provide a definition for these differing types of conflicts.[18] Because of this, one must look to case law to see how courts interpret the distinction between the two. As the court in *In re BH & P, Inc.* describes, "an actual conflict can be defined as an active competition between two interests, in which one interest can only be served at the expense of the other. A potential conflict can be defined as one in which the competition is presently dormant, but may become active if certain contingencies occur."[19]

Often times, determining what type of conflict is present in a litigation is made on a case by case basis.[20] In these fact specific inquiries, courts often treat potential conflicts of interest as less severe than actual conflicts of interest and they are often given more leeway by the court; however, both types of conflicts can result in disqualification of counsel from a proceeding.[21]

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[15] *See id.*
[16] *See* MODEL RULES OF PROF'L CONDUCT r. 1.7 cmt. 6 (AM. BAR ASS'N 1980).
[17] *See id.* at cmt. 8.
[18] *See In re* BH & P, Inc., 103 B.R. 556, 563 (Bankr. D.N.J. 1989).
[19] *Id.*
[20] *See In re* Dick Cepek, Inc., 339 B.R. 730, 740 (9th Cir. 2006) (stating that "the inquiry into whether the professional . . . is impaired by a conflict of interest (actual or potential) is necessarily case– and fact-specific.").
[21] *See In re* Schwindt, 2013 WL 321297, at *3 (Bankr. D.Colo. 2013) (explaining that disqualification of an attorney must result if there is an actual conflict of interest but is not mandatory with potential conflicts); *In re* Pillowtex, Inc., 304 F.3d 246, 251 (3d Cir. 2002)

II. Section 327(c) of the Bankruptcy code is a limited exception to the general rule of employment by professional persons.

Although the Bankruptcy Code does not define what an "actual conflict of interest" is, courts often have broad authority, under section 327(c) of the Bankruptcy Code, to find such a conflict.[22] Section 327(c) provides that "a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest."[23] This statute provides an exception to the general requirements under subsection (a) of this section. If counsel is disqualified *solely* because of their employment by or representation of a creditor in the action then there must be an actual conflict of interest present in order for the court to continue with the disqualification of the counsel. In other words, if there is a potential conflict of interest present because of the firm's representation of both the debtor and a creditor, this would not result in disqualification. In order to have an actual conflict of interest and result in disqualification, there must be a substantial impediment on the firm's representation, and thus an adverse affect on the firm's implementation of its fiduciary duties to its clients.

When the Bankruptcy Code first implemented section 327(c), this development in the law was extremely important because it shifted the focus of whether there was *any* conflict of interest

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(stating that the Bankruptcy Code "imposes a per se disqualification . . . of any attorney who has an *actual conflict of interest*; [however,] the district court may within its discretion . . . disqualify an attorney who has a *potential conflict of interest*").

[22] *See In re* 7677 E. Berry Ave. Assocs., L.P., 419 B.R. 833, 843 (Bankr. D. Colo 2009) (describing subsection (c) as being "commonly referred to as the 'catch-all clause'").

[23] 11 U.S.C. § 327(c).

to whether there was an *actual* conflict of interest present in situations where counsel was disqualified solely because it represented a creditor.[24]

Although counsel has tried to argue that the two sections can be read independently, the majority of courts have held that they must be read together.[25] In other words, in order to meet the requirements of subsection (c), and thus have no actual conflicts of interest, counsel must still meet the requirements of (a), and thus have no interest adverse to the estate and be a disinterested person.[26]

III. The use of independent conflicts counsel is not a viable solution when the adverse interests of the debtors are fundamental to reorganization efforts.

The retention of conflicts counsel can be a viable solution in most cases.[27] The idea is that if "matters in which general bankruptcy counsel's simultaneous representation of more than one debtor would pose a disqualifying conflict of interest are carved out of the scope of general

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[24] *See In re* BH & P, Inc. at 1311 (holding that "[t]he existence of interdebtor claims is, therefore, no longer an automatic ground for disqualification of counsel . . . . Section 327 focuses the inquiry upon whether there is an actual conflict of interest."); *see also In re* 7677 East Berry Ave. Assocs., L.P., 419 B.R. 833, 844 (Bankr. D.Colo. 2009) (holding that "[u]nder this provision, the existence of inter-debtor claims does not create a *per se* prohibition of counsel representing both estates."); *In re* Project Orange Assocs., LLC, 431 B.R. 363, 371 (Bankr. S.D.N.Y 2010) (stating that "Congress has explicitly stated that a professional's representation of a creditor in another case does not automatically disqualify it from being retained").

[25] *See* Interwest Bus. Equip., Inc. v. United States Trustee (*In re* Interwest Bus. Equip.), 23 F.3d 311, 316 (10th Cir. 1994) (stating that "[t]he requirements of subsection (a) are threshold requirements to be met even if subsection (c) is implicated. Subsection (c) addresses the situation where dual representation of a creditor and debtor is the only reason advanced for disqualification and the professional is otherwise qualified."); *In re* Cook, 223 B.R. 782, 790 (10th Cir. 1998) (stating that "subsection (c) does not preempt the more basic requirements of subsection (a) . . . ."); *In re* Schwindt, 2013 WL 321297, at *7 (stating that "[s]ection 327(c) contains a limited exception to the general rule set forth in § 327(a) . . . . Therefore, the Court's inquiry ends where the threshold requirements of § 327(a) are satisfied, unless § 327(c) . . . is implicated.").

[26] *See In re* Interwest Business Equip., 23 F.3d at 316.

[27] *See In re* Project Orange, 431 B.R. at 375 (stating that "[i]n many cases, the employment of conflicts counsel to handle issues where general bankruptcy counsel has an adverse interest solves most questions regarding the retention of general bankruptcy counsel.").

bankruptcy counsel's representation . . . and are assigned to separate independent counsel, no actual conflict of interest can arise."[28] The conflict matters would be outside the scope of the representation, and thus counsel would still be able to conduct this dual representation.[29]

However, if the "areas in which the two companies have adverse interests are such that retention of independent conflicts counsel poses too great a risk that the [firm] would nevertheless be unable to give each debtor its undivided loyalty and provide . . . untainted advice and assistance in furtherance of their fiduciary responsibilities[,]" then conflicts counsel will not be a viable solution.[30] In determining whether conflicts counsel is a viable solution in such cases, courts often look at the type of conflicts of interest involved and how they will affect the lawyers fiduciary duties to its client.[31] If the conflict is merely potential and does not equate to an actual dispute, the court is likely to find conflicts counsel a viable solution. However, if the conflict is an actual one then the lawyer cannot carry out its fiduciary duties to its client adequately and conflicts counsel cannot overcome such a deficiency.

The court in *In re WM Distribution* expanded the rationale behind the majority view that requires an analysis of the type of conflict involved before determining whether conflicts counsel is an appropriate remedy.[32] Conflicts counsel is not a viable solution where "[t]he extent of the areas of adverse interests between the two debtors, which include[d] adverse interests that [were]

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[28] *In re* WM Distribution, 571 B.R. at 873.
[29] *Id.*
[30] *Id.* at 874.
[31] *See In re* National Liquidators, Inc., 182 B.R. 186, 192 (Bankr. S.D.Ohio 1995) (holding concurrent representation among creditors acceptable because "the record fail[ed] to suggest even the remotest possibility of the existence of any actual dispute"); *In re* Rockaway Bedding, Inc., 2007 WL 1461319, at *5 (Bankr. D.N.J. 2007) (approving general counsel because the court "believe[d] that no more than a remote potential conflict [could] be found" and if such conflict situations should arise, separate conflicts counsel was a valid proposed solution); *In re* Enron Corp., 2003 WL 223455, at *5 (Bankr. S.D.N.Y. 2003) (stating that no conflicts were present "because on all relevant issues, Milbank used a separate conflicts counsel.").
[32] *In re* WM Distribution, 571 B.R at 874.

central to their respective reorganization efforts, render[ed] it inappropriate to use of conflicts counsel."[33] In so holding, the court placed emphasis on the attorney client relationship and the fiduciary duty owed to the client by the attorney. Specifically, where the companies were so involved in each other's day to day operations, counsel cannot fulfill its duty to one debtor without sacrificing its duty to the other debtor.[34] While the potential for conflicts of interest were endless, there were numerous actual conflicts of interest present as well.[35] Although courts find conflicts counsel a viable solution when the conflicts of interests involved are only potential, because there were actual conflicts of interest present in this case, conflicts that affected the firm's fiduciary duties owed to each debtor company, conflicts counsel was not a viable solution.

Conclusion

When making determinations about the use of conflicts counsel, courts have to balance the ethical rules and regulations that bind the legal profession with the statutory regulations of the Bankruptcy Code.[36] In an attempt to reserve resources in bankruptcy proceedings, courts will allow the use of conflicts counsel in litigations where the conflict of interest present is only potential because such potential conflicts do not affect the lawyers fiduciary duty to its client; however, if the conflict involves an actual dispute that affects these duties, the court will not allow such a solution.

By focusing on the fiduciary duties owed by an attorney to its client, the court in *In re WM Distribution* aligned the underlying policy of subsection (c) of Section 327 with those underlying subsection (a), thus reinforcing the idea that these two subsections must be read

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[33] *Id.*
[34] *See id.* (stating that "STM and WM Distribution need separate counsel to advise the companies as to what is in the best interest of each company regarding their continuing business relationship so each company can best formulate its chapter 11 plan.").
[35] *See id.* at 871.
[36] *See* Rotunda, *Resolving Client Conflicts by Hiring "Conflicts Counsel"* at 697.

together. Although counsel may overcome a disqualification based on a conflict of interest, the method to do so is limited. The use of independent conflicts counsel will not be available when the adverse interest of the parties are fundamental to their reorganization efforts.