Use of Conflicts Counsel and Ethical Walls to Resolve Ethical Conflicts

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I. Introduction

While commercial bankruptcies may have slowed in 2013, the eleven largest bankruptcies in United States corporate history were filed since 2001.[1] These cases include American Airlines, MC Global, Enron, Washington Mutual, Chrysler and General Motors to name a few. The size and complexity of bankruptcy cases, like many other areas of the law, continues to grow. There has also been unprecedented growth in mergers not only in the legal market, but also in the financial industry. These changes are set against a backdrop of intense and rapid technological advances and globalization that are altering the very way law is practiced and how law firms are structured. As financial institutions continue to consolidate and law firms, through expansion and/or merger, continue their growth, it becomes more and more difficult to find law firms with the resources to take on the larger cases that don't have some type of conflict or potential conflict of interest.

This article discusses the disinterestedness and adverse interest standard imposed under the Bankruptcy Code for professionals retained by a trustee, debtor or committee in a chapter 7 or chapter 11 bankruptcy case, and the use of both conflicts counsel and ethical walls to cure potential conflicts.

II. Disinterestedness and Adverse Interests

Section 327(a) of the Bankruptcy Code governs the general employment of professionals by a debtor in possession or trustee to represent the estate.[2] Such employment requires court approval.[3] The statute reads:

> (a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, 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) imposes two requirements for retention of professionals by the debtor in possession or a trustee. The professionals to be employed must be both (1) disinterested and (2) not hold or represent any interest adverse to the estate.[4]

Section 1103 of the Bankruptcy Code sets forth the requirements for retention of a professional by either a creditors or equity security holders committee. Unlike section 327, section 1103 lacks a disinterested requirement. Thus, on its face section 1103 is more relaxed in its retention requirements when compared to section 327; however, section 1103 does provide that counsel may not "while employed by such committee, represent any other entity having an adverse interest in connection with the case. Representation of one or more creditors of the same class as represented by the committee shall not per se constitute the representation of an adverse interest."[5]

While section 1103 lacks a disinterested requirement, the section governing actual payment to employed professionals appears to impose a disinterestedness requirement on all professionals employed under either section 327 or 1103. Section 328 sets forth the standards governing court approval of compensation to all estate retained professionals, including those retained under both section 327 and section 1103.[6] Section 328 provides that the court may deny compensation to any professional retained under either section 327 or 1103 if, at any time during such professionals' employment, the professional "is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed."[7]

Thus, while proposed counsel for the debtor is subject to stricter requirements under section 327 than proposed counsel for a committee under section 1103, both section 327 and 1103 have an adverse interest

[1] Shira Ovide, *MF Global: Likely Among the 10 Biggest Bankruptcies Ever*, WALL STREET JOURNAL, Oct. 31, 2011, http://blogs.wsj.com/deals/2011/10/31/mf-global-likely-among-the-10-biggest-bankruptcies-ever/?mod=e2tw (last visited on January 1, 2014).

[2] 11 U.S.C. §§ 327(a).

[3] *Id.*

[4] 11 U.S.C. § 327(a); *In re American Intern. Refinery, Inc.*, 676 F.3d 455, 461 (5th Cir. 2012).

[5] 11 U.S.C. § 1103(b)

[6] *See* 11 U.S.C. § 328.

[7] 11 U.S.C. § 328(c).

requirement. Moreover, section 328 provides the bankruptcy court the authority to deny compensation to professionals employed under either statute if the professional is not disinterested or has an adverse interest to that of the estate.[8]

Whether an interest is adverse to the estate is determined on a case by case basis.[9] In the Fifth Circuit, the standards for finding a conflict are "strict" and "attorneys engaged in the conduct of a bankruptcy case 'should be free of the slightest personal interest which might be reflected in their decisions concerning matters of the debtor's estate or which might impair the high degree of impartiality and detached judgment expected of them during the course of administration.'"[10]

The Bankruptcy Code defines "disinterested" as a person (1) who "is not a creditor, an equity security holder, or an insider," (2) who "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 (3) who "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."[11]

The Fifth Circuit in *West Delta Oil* determined that a party has an adverse interest to the estate if it "(1) [ ] possess[es] or assert[s] any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant; or (2) possess[es] a predisposition under circumstances that render such a bias against the estate."[12] Applying this definition, a court examining whether a professional has a materially adverse interest to the estate examines the specific facts of each case and "with attention to circumstances which may impair a professional's ability to offer impartial, disinterested advice to his or her client."[13]

III. The Duty and Scope of The Disclosure Requirements under Rule 2014

Performing in tandem with the requirements of section 327 and section 1103, Bankruptcy Rule 2014 imposes certain disclosure requirements to enable the court and interested parties to determine whether a professional is disinterested or holds an interest materially adverse to the estate.[14] Without full disclosure the court cannot determine whether retention of the proposed professional is proper or not. The disclosure requirements are strictly construed and a professional subject to them "must disclose all facts that bear on disinterestedness and cannot usurp the court's functions by selectively incorporating materials the proposed professional deems important."[15]

Federal Rule of Bankruptcy Procedure 2014(a) requires proposed professionals seeking retention by a debtor in possession, a trustee or a committee to disclose in a verified statement "all" connections with (1) the debtor, (2) creditors, (3) any other party in interest, (4) their respective attorneys and accountants, (5) the United States trustee, or any person employed in the office of the United States Trustee.[16]

Moreover, full disclosure is a continuing responsibility and an attorney is under a duty to promptly notify the court if any potential conflict arises for the duration of his employment in the case.[17] Firms that fail to timely and completely disclose connections risk revocation of their employment and denial of compensation.[18]

IV. Not Disinterested? Have a Potential Conflict? Is There a Cure?

More and more courts are recognizing that "conflicts counsel" and ethical walls can mitigate or eliminate a conflict if it would otherwise exist. Courts appear to be more willing to recognize these measures

8 *Id.*
9 *In re West Delta Oil Co.*, 432 F.3d 347, 355 (5th Cir. 2005).
10 *Id.* (quoting *In re Consol. Bancshares, Inc.*, 785 F.2d 1249, 1256 & n.6 (5th Cir. 1986)).
11 11 U.S.C. § 101(14).
12 *In re West Delta Oil Co.*, 432 F.3d at 356.
13 *Id.*

14 *See* FED. R. BANKR. P. 2014.
15 *In re Enron Corp.*, 2002 WL 32034346, at *5 (Bankr. S.D.N.Y. May 23, 2002).
16 FED. R. BANKR. P. 2014(a).
17 *In re West Delta Oil Co.*, 432 F.3d at 355.
18 *Id.* (citing *In re Crivello*, 134 F.3d 831, 836 (7th Cir. 1998)).

as satisfactorily eliminating or neutralizing conflicts, particularly in larger bankruptcies where conflict issues are more prevalent. While there are few case holdings on point, there is strong authority supporting the proposition that a conflict of interest can be cured or eliminated by the employment of conflicts counsel and/or the establishment of ethical walls.

The remainder of this article explores each of the legal constructs—conflicts counsel and ethical walls—when implementation of each is appropriate, and the components of each.

A. Conflicts Counsel – Case Studies

There are a number of issues that may result in a debtor in possession or committee being precluded from employing its counsel of first choice. The larger the bankruptcy case, the more likely such conflict may arise because it becomes more likely that proposed counsel has some relationship with parties in interest unrelated to the bankruptcy case. One method recognized by courts to avoid having to disqualify counsel is through the use of separate "conflicts counsel." The role of conflicts counsel is to address those matters where the primary bankruptcy counsel is precluded from taking action because of potential conflict issues.

1. When Conflicts Counsel is <u>Insufficient</u> to Avoid Disqualification of Counsel

<u>In re Project Orange Associates, LLC</u>

In the case of *In re Project Orange Associates, LLC*, the bankruptcy court addressed whether use of conflicts counsel to deal with the debtor's largest unsecured creditor and essential supplier was sufficient to permit court approval under section 327(a) of the Bankruptcy Code of a debtor's general bankruptcy counsel.[19]

The debtor presented its application to employ DLA Piper LLP (US) ("DLA Piper") as its primary bankruptcy counsel, pursuant to 11 U.S.C. 327(a). The debtor was in the electricity generation business. It owned and operated a steam and electric power facility (the "Facility") on land owned by Syracuse University. The Facility provided electricity generation services to the New York Independent System Operator. The debtor asserted that its financial troubles arose from three matters. First, the deregulation of the New York State energy market; second, ongoing litigation with Syracuse University related to the Facility; and third, maintenance issues with two electric turbines that were manufactured and maintained by General Electric ("GE").

The operation of the GE manufactured turbines was critical to the debtor's operations. A maintenance agreement between the debtor and GE governed the relationship between the parties with respect to the turbines. Repeated breakdowns and maintenance actions throughout 2008 led to disputes between GE and the debtor over amounts due under the maintenance agreement. Through arbitration GE obtained an award of $4,113,017.00 against the debtor.

The debtor took the position that "all major litigation with GE has been resolved."[20] The debtor and GE entered into a settlement stipulation, the terms of which called for certain payments to be made to GE after which GE would deliver and install a gas generator and certain spare parts at the Facility. At the time the application to employ general bankruptcy counsel, the settlement had not yet been approved by the bankruptcy court. Further, GE was the largest unsecured creditor in the case.

In its initial disclosure declaration, DLA Piper disclosed that the GE affiliate, which was a creditor in the case, General Electric International, Inc. ("GEII") was not and never had been a client of DLA Piper, but instead was a client of DLA Piper International, LLP ("DLA International") a separate affiliate of DLA Piper. Contrary to that position, DLA Piper obtained a conflicts waiver from GEII which treated GEII and GE as one entity. The conflicts waiver stated that it would "not bring any litigation or threaten any litigation for the recovery of monetary damages from *GE or its affiliates* or for any equitable relief against *GE or any of its affiliates*."[21] To resolve the potential conflict issue, the debtor retained Golenbock Eisman Assor Bell & Pesoke LLP ("Golenbock") as its conflicts counsel. Golenbock was tasked with handling any matters for which DLA Piper could not adequately represent the debtor, including issues regarding GEII.

[19] 431 B.R. 363, 365 (Bankr. S.D.N.Y. 2010).

[20] *Id.* at 367.

[21] *Id.* at 369 (emphasis added).

The *Project Orange* court was not impressed. It found that neither the retention of conflicts counsel nor the conflict waiver were sufficient to cure DLA Piper's conflict. The court held that under the plain language of the statute, if there is an actual conflict of interest, the court must disapprove the employment under section 327.

The court ruled that the purported conflicts waiver "severely undermines DLA Piper's effort to segregate its relationship with GEII."[22] First, the waiver was sent by DLA Piper not DLA International. Second, the waiver was addressed to GEII "care of" a GE attorney. Third, and perhaps most damaging, the conflicts waiver combined GEII and GE into a single entity, when requesting a waiver. Based on these findings the court refused to accept DLA Piper's efforts to draw "artificial lines in an attempt to isolate itself from GEII."[23] Because the conflicts waiver treated GEII and GE as a single entity, the court found it proper for the court to treat them as a single entity for conflict purposes as well.

Further, because of limitations placed on DLA Piper's ability to file suit against GE or its affiliates, the court found that DLA Piper was unable to act in the best interest of the debtor with respect to GE. The court did not believe that DLA Piper could properly negotiate with full efficacy without the ability to at least threaten or hint at litigation.

Focusing on the purported stipulation and the debtor's contention that the parties were no longer adverse, the court noted that until the stipulation was approved by the court via a Rule 9019 motion, the stipulation was not effective; and, moreover, even if it was approved, until the repairs and installation were complete, the debtor and GE would remain "wholly adverse."[24] The court found that these issues created a clear conflict of interest for DLA Piper.

Turning to the use of conflicts counsel to cure DLA Piper's conflict, the court held that where the proposed general bankruptcy counsel has a conflict of interest with a creditor that is central to the debtor's reorganization, conflicts counsel would be insufficient to insulate it from the conflict of interest. Moreover, even if conflicts counsel performed all work related to GE, "the fig leaf of conflicts counsel does not convince the court that retention of DLA Piper as general bankruptcy counsel is appropriate" where GE is central to the case.[25] The court noted that "it does not appear that DLA Piper can fairly and fully advise in the negotiation and drafting of a plan when it may not even be able to advocate litigation against GE."[26]

Ultimately, the court denied the application and held that where the proposed general bankruptcy counsel has a direct conflict with the debtor's largest unsecured creditor, and that creditor is central to the success of the bankruptcy case, use of conflicts counsel and conflicts waiver are insufficient to cure the conflict and allow the employment of the proposed general bankruptcy counsel.

In re Git-N-Go, Inc.

The debtor in *In re Git-N-Go, Inc.* sought approval of Conner & Winters as its general bankruptcy counsel pursuant to section 327(a) of the Bankruptcy Code.[27] The conflict issue arose because the proposed counsel represented not only the debtor, but also its parent and one of the debtor's largest unsecured creditors.

Proposed counsel's Rule 2014 disclosures revealed that it had an ongoing relationship with the debtor's parent company, Hale-Halsell Company ("Hale-Halsell"). Prepetition, the debtor guaranteed approximately $13 million of Hale-Halsell debt owed to F&M Bank and Trust Company ("F&M Bank"). The debtor also pledged all of its prepetition assets to secure the guarantee. Likewise, Hale-Halsell guaranteed the debtor's debt to F&M Bank in the amount of approximately $3.2 million. Conner & Winters, the debtor's proposed bankruptcy counsel, represented both Hale-Halsell and the debtor in the loan and guarantee transaction with F&M Bank. In total, the debtor asserted that Hale-Halsell's claim against it totaled approximately $9 million, $6 million of which was subordinated to F&M Bank's secured claim. Further, Conner & Winters had represented Hale-Halsell for decades and was currently representing it in its efforts to restructure its own portfolio and, if necessary, would represent Hale-Halsell in its own bankruptcy.

Finally, one of the primary motivations in Git-N-Go's filing for bankruptcy arose after Citgo began withholding hundreds of thousands of dollars of gasoline receipts owed to the debtor as an offset for a debt Git-N-Go had guaranteed for one of its subsidiaries. Conner & Winters disclosure revealed

[22] *Id.* at 371.
[23] *Id.*
[24] *Id.* at 373.
[25] *Id.* at 375.
[26] *Id.* at 377.
[27] 321 B.R. 54 (Bankr. N.D. Okla. 2004).

that it represented Citgo in matters unrelated to the debtor and that fees from Citgo amounted to approximately 1% of its previous year's revenues.

In an effort to alleviate concerns regarding this relationship, Conner & Winters first obtained a conflicts waiver from Citgo. Next, Conner & Winters refrained from actively contesting Citgo's setoff of the Debtor's gasoline receipts and instead advised the debtor to obtain conflicts counsel to challenge Citgo's actions. The debtor subsequently sought and the court approved retention of conflicts counsel.

In its decision regarding employment of Conner & Winters, the court found that given the intermingling of debt and guarantees between the debtor and Hale-Halsell, an examination of those underlying transactions would be required. Because Conner & Winters had counseled both the debtor and Hale-Halsell on those transactions it would be unable to provide objective, independent advice regarding those transactions' validity or propriety. The court noted that Conner & Winters' disinterestedness did not arise solely because it represented a creditor in an unrelated matter. On the contrary, Hale-Halsell was not just a creditor. It was a co-debtor and the majority shareholder of the debtor. Moreover, Conner & Winters could not perform an unbiased, fresh review of the transactions between the debtor and Hale-Halsell because it had advised both parties in those transactions. Analysis of such claims and their validity by the debtor would be necessary for it to satisfy its fiduciary duty to its creditors in the bankruptcy case.

Further, in responding to the employment of "conflicts counsel," the court noted that it originally permitted employment of conflicts counsel because of the emergency nature of the request–i.e. Citgo was actively withholding and purportedly setting off hundreds of thousands of dollars of gasoline receipts. However, it noted that the bulk of the issues Conner & Winters sought to push onto conflicts counsel were core bankruptcy matters that required considerable chapter 11 experience and expertise. The court insinuated that such volume and the core nature of the work sought to be referred to conflicts counsel was improper and should be handled by disinterested general bankruptcy counsel.

While acknowledging that disqualification of debtor's counsel is a harsh result, the court found that Connor & Winters' representation of interests adverse and potentially adverse to the estate precluded its employment as counsel for the debtor in possession under section 327(a).

2. When Conflicts Counsel is Sufficient to Avoid Disqualification of Counsel

In re Washington Mutual, Inc.

In *In re Washington Mutual, Inc.*, the conflict issue and use of conflicts counsel arose in the context of plan confirmation.[28] In the chapter 11 bankruptcy case of Washington Mutual, Inc. and its related affiliates, the debtors sought approval of their sixth plan. The plan was premised on the terms of a global settlement reached by the debtors and JPMorgan Chase Bank, N.A. ("JPMC"). The global settlement proposed to resolve several disputes with JPMC including: (i) a complaint failed by JPMC wherein it alleged that when it acquired Washington Mutual Bank (WMB), it acquired certain funds on deposit at WMB in the names of the debtors, valued at approximately $3.8 billion, certain tax refunds valued at $5.5 to $5.8 billion and certain securities valued at $4 billion; (ii) counterclaims of the debtors asserting ownership of the above disputed assets and seeking to avoid as preferences and fraudulent transfers certain pre-petition capital contributions they made to WMB; and (iii) a turnover action commenced by the debtors against JPMC seeking turnover of the $3.8 billion held in the deposit accounts.

Certain parties objected to confirmation, in part, based on the fact that debtors' lead counsel and chief restructuring officer also represented JPMC in unrelated matters. For this reason, the objecting parties argued, the debtors' counsel had been reluctant to push for the best possible deal for the debtors' estates.

In its original retention application, counsel for the debtors disclosed that the firm presently represented JPMC in unrelated matters. Additionally, the proposed counsel disclosed that pursuant to its conflict letter, proposed counsel's ability to file suit against JPMC with respect to the dispute over the deposit accounts was not restricted. However, it was prohibited from filing suit against JPMC for any lender liability or avoidance actions. Conflicts counsel was employed by the debtors to pursue these other claims against JPMC.

[28] 2011 WL 57111 (Bankr. D. Del. Jan. 7, 2011).

In its opinion the court found no evidence demonstrating that any of the professionals failed to adequately represent the interests of the bankruptcy estates. Further, the court noted that during the course of the case, partially through conflicts counsel, the debtors engaged in "contentious and hard-fought" litigation with JPMC.[29]

In its holding, the court distinguished this case from *Project Orange*. Unlike *In re Project Orange*, the ability of the proposed counsel to Washington Mutual to bring suit against JPMC was not severely limited. Counsel was able to threaten and prosecute the deposit account issue which appeared to be one of the larger issues in the case. Based on that and the debtors' employment of conflicts counsel to litigate the other claims against JPMC, the court determined that the settlement was not tainted by any conflict of interest with JPMC.

<u>*In re Rockaway Bedding, Inc.*</u>

Before the court in *In re Rockaway Bedding, Inc.* was an application to employ Duane Morris LLP ("DMLLP") as the debtor's bankruptcy counsel.[30] The United States Trustee objected based on DMLLP's previous and ongoing representation of certain pre-petition creditors, especially PNC Bank. PNC Bank was the debtor's pre-petition lender and largest secured creditor with a claim of over $3.4 million secured by a blanket lien on substantially all of the debtor's assets. Early in the case and prior to the application to employ being considered, DMLLP negotiated two cash collateral orders on behalf of the debtor with PNC Bank.

The court noted that potential conflicts of interest existed. It then noted that .68% of DMLLP's gross revenues in 2006 came from PNC Bank. It also noted that one of the proposed attorneys maintained a personal account at PNC Bank and that DMLLP had connections with other pre-petition creditors.

To resolve any possible conflicts issues, DMLLP proposed the following measures. First, PNC Bank and DMLLP executed a conflicts waiver. DMLLP was authorized to provide the debtors with services as bankruptcy counsel. The only exception was that DMLLP agreed not to assert any claim of fraud, misrepresentation or dishonest conduct against PNC Bank in connection with the chapter 11 proceeding. If such claims arose, the debtor would retain conflicts counsel or allow the official creditors' committee to pursue those claims against PNC Bank.

Second, the bankruptcy proceeding was being handled by counsel in DMLLP's New Jersey office. DMLLP established an ethical wall on its firm-wide computer system which separated its professionals who had or would perform unrelated services for PNC Bank from the DMLLP professionals in the New Jersey office and prevent possible disclosure of any privileged or confidential information between the two offices.

The court determined that at the time of the application to employ, there was no actual conflict of interest requiring denial of the application. There was no active litigation. DMLLP had zealously represented the debtor's interests against PNC Bank in negotiating the cash collateral orders. The court also found that replacement of bankruptcy counsel would be irreparable at the current juncture of the case—while the debtor was in the middle of downsizing its operations to reduce costs and return to profitability. Further, the court noted that PNC Bank represented less than 1% of DMLLP's 2006 gross annual revenue. Finally, and "[m]ost significantly, . . . the conflicts waiver . . . specifically provid[ed] for independent representation [by conflicts counsel] on matters related to fraud or misrepresentation . . . ."[31]

Based on the resolutions proposed by DMLLP—including employment of conflicts counsel where necessary—the importance of DMLLP to the debtors' reorganization, and the speed and diligence of DMLLP to disclose and address these issues, the court granted the debtors' application to retain DMLLP.

3. Conflicts Counsel Summary

While the courts are not uniform on their acceptance of the use of conflicts counsel, analysis of the above case law indicates that there are some common issues that a practitioner should consider when seeking to use conflicts counsel to avoid a potential conflict situation.

First, it is clear that if there is an actual conflict, i.e., the conflict already exists, use of conflicts counsel will be insufficient to cure the conflict and the debtor, trustee or committee will need

[29] *Id.* at *6.

[30] 2007 WL 1461319 (Bankr. D.N.J. 2007).

[31] *Id.* at *3.

to seek alternative general bankruptcy counsel. If an actual conflict of interest exists then the proposed counsel cannot pass the required disinterestedness test required by 11 U.S.C. § 327(a).

Second, as noted in *Project Orange*[32] and *Washington Mutual*,[33] whether conflicts counsel is employed or not, if the potential conflict is with a major or key creditor to the debtor and the resulting conflict waiver severely limits general bankruptcy counsel's ability to deal with the creditor (including the ability to threaten and pursue litigation), then the court will likely find that the employment of conflicts counsel is insufficient to inoculate proposed general counsel. However, at least with respect to those courts that follow the Washington Mutual decision, if the proposed counsel's ability to sue the major or key creditor is only limited to certain discrete issues, employment of conflicts counsel to address those discrete issues may by sufficient to allow proposed counsel to be employed under 11 U.S.C. § 327(a). However, if proposed counsel cannot negotiate with the debtor's primary creditor and have all of its tools, including the ability to threaten litigation, and that creditor is key to the case, the courts appear to find that the proposed general counsel cannot act in the best interest of the debtor's estate and its creditors.

Third, conflicts counsel cannot be assigned a significant amount of "core bankruptcy" matters. The *In re Git-N-Go* court insinuated that conflicts counsel cannot be employed to handle a significant amount of "core bankruptcy matters" and the debtor's attempt to do so was improper.[34] Instead, such tasks should be handled by disinterested general bankruptcy counsel. While no other cases identified raised this "core" requirement, this issue is similar to the discrete scope of employment discussed above. When seeking to employ conflicts counsel, it appears that the larger the proposed scope of conflicts counsel's employment, the higher the court will scrutinize the employment of proposed general bankruptcy counsel as well as proposed conflicts counsel.

Finally, both the *Git-N-Go* court and the *Rockaway Bedding* court considered the amount of revenue the creditor brought to the proposed counsel in the prior year. While neither court established any parameters regarding the level of prior revenue required to raise a disinterestedness issue, practitioners should note that the court may examine this issue when determining whether employment of conflicts counsel cures whatever potential conflict the proposed general counsel may have.

4. New United States Trustee Guidelines

For bankruptcy practitioners considering the use of conflicts counsel to cure potential conflicts for general bankruptcy counsel being employed under 11 U.S.C. § 327(a), it should also be noted that in June 2013, the United States Trustee's office issued new guidelines for reviewing the employment and compensation applications of attorneys in "large" bankruptcy cases. Large for these purposes is where assets and liabilities exceed $50 million. The guidelines acknowledge that the use of conflicts counsel can be used to cure nonpervasive conflicts faced by the proposed lead counsel. The guidelines assert that the US Trustee's office should examine proposed conflicts counsel's retention to assure that lead counsel's conflicts are not so pervasive as to transform conflicts counsel to general bankruptcy counsel.

The guidelines establish the following circumstances that weigh against the employment of conflicts counsel to cure proposed lead counsel's conflict of interest:

i. The responsibilities of conflicts counsel are not confined to discrete legal matters.

ii. Conflicts counsel will be used to handle matters that are inseparable from the major reorganization activities of the case (e.g., negotiation of major plan provisions).

iii. Conflicts counsel will act under the direct supervision of, and at the direction of, the lead counsel.

iv. Conflicts counsel's role will include filing or advocating pleadings that have been drafted by lead counsel.

v. Conflicts counsel has been retained to litigate matters in which the lead counsel has represented the debtor in settlement negotiations.

vi. The debtor will not (or cannot) create an ethical wall to screen the

[32] 431 B.R. 363.
[33] 2011 WL 57111.
[34] 321 B.R. at 62.

lead counsel from the work of the conflicts counsel.[35]

B. Ethical Wall – Case Studies

Another method recognized by courts to avoid having to disqualify counsel because of a potential conflict is through the use of "ethical walls." Often, bankruptcy courts will impute disqualification of one attorney within a firm to the entire law firm. Some courts have determined that implementation of ethical walls by law firms prevent this imputation of a conflict to the entire law firm by effectively screening the lawyer or lawyers from the matter. As demonstrated below, courts are split over whether and to what extent the use of an ethical wall prevents imputation of a conflict to an entire law firm.

1. When an Ethical Wall is <u>Insufficient</u> to Avoid Imputation of a Conflict to the Entire Firm

<u>*In re Essential Therapeutics, Inc.*</u>

In *In re Essential Therapeutics, Inc.*, the debtors—biopharmaceutical companies—sought chapter 11 protection and sought to retain Bingham McCutcheon ("Bingham") as their bankruptcy counsel.[36] The United States Trustee objected to the application on the basis that a partner at Bingham held the position of "Secretary" with several of the debtors within two years of the filing of the petition in violation of 11 U.S.C. 327(a). As set forth above, Section 327(a) requires the debtors' professionals be "disinterested persons," which Section 101(14) defines as a person that "is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor."

The court first reviewed the issue of whether the Bingham partner was an officer of the debtors. The debtors took the position that, though he held the position of "Secretary," the partner performed only the ministerial acts of attending board meetings and keeping minutes, and did not perform any executive actions. The United States Trustee argued that the statute was clear on its face and "means what it says." The court agreed with the Trustee and strictly applied Sections 101 and 327.

The next issue examined by the court was whether Section 1107(b) nevertheless allowed the employment of the partner. That section states, "Notwithstanding section 327(a) of this title, a person is not disqualified for employment, under section 327 of this title by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case." Agreeing with the United States Trustee, the court found that the subsection cannot defeat an independent reason for disqualification such as when the professional was not a "disinterested person." The court narrowly construed 1107(b) and held that the subsection is not meant to eliminate all specific tests for disqualification, but instead only applies to the prior employment or retention test.

Finally, the court addressed whether the disqualification of one lawyer disqualifies the entire firm. The court reviewed the split of authority on the question of whether an ethics wall was sufficient. The debtors argued that only where there is an actual conflict will an ethics wall fail. The court cited to a number of opinions where lawyers had served as officers of the debtor, as here, and even though there was no actual conflict, the entire firm was disqualified. The court found that imposition of an ethical wall would create a "Herculean task" wherein it would have to interrogate each person in the conflicted firm to determine whether the taint of an imputed conflict had spread. Ultimately, the court held that not imputing the conflict to the entire firm would be unworkable, that Congress had enacted Section 101(14)(D) because service as an officer would affect the independence and disinterestedness required of estate counsel, and that it was possible that the officers and directors would be sued for their role in the debtors' bankruptcy.

<u>*Mitchell v. Metro. Life Ins. Co., Inc.*</u>

In this case a group of plaintiffs asserted a gender discrimination suit against Metropolitan Life Insurance Company ("Metlife").[37] The complaint alleged that Metlife discriminated on gender grounds in all aspects of employment, including hiring,

[35] Executive Office for United States Trustees, Justice, Appendix B–*Guidelines for Reviewing Applications for Compensation and Reimbursement of Expenses Filed under 11 U.S.C. § 330 by Attorneys in Larger Chapter 11 Cases*, p. 25, dated June 11, 2013; http://www.justice.gov/ust/eo/rules_regulations/guidelines (last visited on January 20, 2014).

[36] 295 B.R. 203 (Bankr. D. Del. 2003).

[37] 2002 WL 441194 (S.D.N.Y. Mar. 21, 2002).

promotions, and compensation. One of the two law firms hired to represent the plaintiffs against Metlife was Lieff, Cabraser, Heimann & Bernstein, LLP ("Lieff Cabraser"). Wendy R. Fleishman ("Fleishman") was the partner whose conflict of interest Metlife argued should disqualify Lieff Cabraser from representing the plaintiffs. Fleishman joined the firm two months prior to the filing of the plaintiffs' cause of action, coming from Skadden, Arps, Slate, Meagher, and Flom LLP ("Skadden"). While at Skadden, Fleishman had been involved in defending the specific group within Metlife being sued by the plaintiffs. The court found that, while Fleishman was not involved in defending Metlife against employment discrimination suits, she was sufficiently involved with the group to be familiar with confidential information about the group's operations, policies, and procedures, information that would be highly relevant at trial. In fact, the Court noted that in the two years prior to joining Leiff Cabraser, Fleishman had amassed 1800 and 1540 hours on Metlife matters, respectively.

The court used the American Bar Association's Code of Professional Responsibility to evaluate the nature of Fleishman's conflict. The court agreed with Metlife that Fleishman was subject to a personal conflict of interest based on the facts above. The court then imputed that conflict of interest to the entire firm despite Lieff Cabraser's attempt to prove that Fleishman was effectively screened from any involvement or input in the Metlife suit.

In imputing the conflict, the court took a very narrow view of whether screening procedures could be effective to avoid the disqualification of a law firm based on the personal conflict of interest of one attorney. The court started the analysis by stating that in the Second Circuit screening procedures should be rejected if there is any doubt as to their effectiveness. The court noted that "[t]he Second Circuit has expressed consistent skepticism about screening as a remedy for conflicts of interest . . . [and that c]ourts have only approved screening in the limited circumstances where a conflicted attorney possesses information unlikely to be material to the current action and has no contact with the department conducting the current litigation . . . ."[38] The court also noted that the validity of screening is undermined by the fact that the New York Code of Professional Responsibility does not generally recognize screening procedures and the ABA House of Delegates had rejected screening as a method to avoid disqualification. So, while the court did not hold that screening is universally ineffective, it indicated that it is not particularly favored.

The facts noted by the court in its decision to impute the conflict included: that the conflict counsel failed to circulate a memorandum outlining the details of the ethics wall until two months after Fleishman joined the firm (and four days prior to filing suit); that there were only 12 attorneys in that office of Leiff Cabraser; and that Fleishman was working closely on a different case with one of the Leiff Cabraser attorneys who was working on the Metlife case. The court found that these facts gave rise to a "continuing danger that Fleishman may inadvertently transmit information" from her previous work with Metlife such that "the presumption of shared confidences has not been rebutted."

2. When an Ethical Wall is <u>Sufficient</u> to Avoid Imputation to the Entire Firm

<u>*In re Enron Corp.*</u>

This case is one of many surrounding the 2002 Enron Corporation ("Enron") bankruptcy. Exco Resources, Inc. ("Exco"), a creditor of Enron, challenged the retention of Milbank, Tweed, Hadley & McCloy LLP ("Milbank") as counsel for the Unsecured Creditor's Committee (the "Committee") in the bankruptcy case.[39] Exco challenged the retention based broadly on both the Bankruptcy Code and the Code of Professional Responsibility. In particular, Exco contended that Milbank should be disqualified because it failed to disclose conflicts and connections it had with the debtors, creditors, and Committee members; it did not satisfy the "disinterested person" standard and it held a disqualifying "adverse interest" under the Bankruptcy Code; and the retention violated the Canons of Professional Ethics and the Disciplinary Rules.

The first issue Exco had with Milbank's employment was that the firm failed to sufficiently disclose various connections and relationships per Bankruptcy Rule 2014. Particularly, Exco alleged that Milbank represented the Committee at the same time that it represented an Enron subsidiary. The Bankruptcy Court, and the District Court on appeal, found that the disclosures were adequate. Additionally, Exco claimed that Milbank somehow

[38] *Id.* at *9.

[39] 2003 WL 223455 (S.D.N.Y. Feb. 3, 2003).

controlled an auction sale of a unit of Enron, only allowing its clients to bid. The courts found both that the disclosures were adequate as to Milbank's relationships with those entities, and also that the debtor's representations that it was the only party controlling the auction process were sufficient to discount any appearance of a continuing conflict. The District Court went on to find all further disclosure-related issues to have been validly disclosed by Milbank and that Rule 2014 disclosure requirement did not require the level of detail in disclosures that Exco would have required.

Exco next asserted that Milbank had disqualifying adverse interests under 11 U.S.C. § 1103(b). Exco was concerned with the fact that Milbank had represented some of the entities in structured finance transactions prior to representing the Committee. The Bankruptcy Court looked at the procedures Milbank had in place related to those representations and determined that they were sufficient to prevent the adverse interest from disqualifying Milbank, and the District Court agreed. The specific procedures put in place by Milbank included a narrow scope of employment in its representation of the Committee, putting in place conflicts counsel to review the docket and pleadings and identify matters Milbank should be excluded from, and what the District Court labeled a "firewall" to separate the individuals at Milbank who handled those previous transactions from those handling the Committee work. The Bankruptcy Court, and the District Court, found that these procedures, taken together, were sufficient to keep Milbank from having a disqualifying adverse interest.

Further, when considering Exco's argument under the Code of Professional Responsibility, the District Court looked at the ethics wall put in place by Milbank and found that it, along with Milbank's use of conflicts counsel, was sufficient to keep Milbank from violating any of the Ethical Canons.

The District Court did not provide any significant detail on how Milbank excluded the individuals who worked on the structured finance transactions from those working for the Committee. However, the case is notable for two things: (a) under certain factual circumstances, and when combined with other protections for those involved, a law firm can effectively use an ethics wall to screen out those attorneys who might cause the firm to be otherwise disqualified in bankruptcy; and (b) at least in the Southern District of New York, and at least with the right size of firm, attorneys having adverse interests can co-exist without violating the Code of Professional Responsibility. While the size of the firm likely played a key role in the effectiveness of the ethical wall in this case, the District Court particularly honed in on the extensive use of conflicts counsel and the independent nature of that counsel's review of each matter as a significant protective mechanism.

<u>*In re McLaren*</u>

The ethical wall issue in *McLaren* arose in the context of a contentious converted Chapter 11 case featuring discovery disputes, motions for sanctions, and an adversary proceeding through which certain of the debtor's creditors (the "Plaintiffs") sought a determination that their claims were non-dischargeable.[40] Just prior to trial of the non-dischargeability issue, the debtor filed a motion seeking to disqualify counsel for the Plaintiffs on the basis that the law firm ("Former Counsel"), which had formerly represented the debtor and subsequently merged with the law firm ("Plaintiffs' Counsel") that was currently representing the Plaintiffs. In effect, the debtor sought to impute the potential conflict of interest from the old law firm to the entire merged firm.

Former Counsel's representation of the debtor terminated in June 1987, at least a year and a half before the filing of the petition for relief (December 1988). However, an attorney with Former Counsel, James Griffith, had represented the Debtor as far back as 1958. Moreover, Mr. Griffith had continually represented the debtor since the 1970's and continued to do so once joining Former Counsel in 1985. In fact, while representing the debtor, Mr. Griffith handled virtually all of the debtor's personal and business legal affairs, including the organization of various corporations and other legal entities. Moreover, according to the debtor, Mr. Griffith counseled the debtor with respect to the claims of his creditors, including those of the Plaintiffs.

In 1990, Former Counsel and Plaintiffs' Counsel merged. During the merger, handling of the litigation against the debtor was brought up and discussed extensively. Ultimately, it was decided that Former Counsel and the attorneys within Plaintiffs' Counsel handling the Plaintiffs' case were to have no contact with each other relating to the debtor and that all related files would be segregated and locked up. Former Counsel and Plaintiffs' Counsel, now at the same firm, worked in different buildings, in different departments, had only "perfunctory contact," and had

[40] 115, B.R. 922 (N.D. Ohio 1990).

discussed the debtor on only two occasions, both well before the merger.

The court began its legal analysis by discussing Rules 5-105(D) (Conflicts or Potential Conflicts) and 4-101 (Preservation of Client Confidences) of the ABA Model Code of Professional Responsibility. The court observed that Rule 5 expressly disqualifies the partners and associates of a tainted lawyer, and thus prohibits the use of ethical walls. However, the court further explained that Rule 5 only relates to conflicts or potential conflicts as between current clients, and therefore was inapplicable to the instant case because the debtor was a former client.

The court observed that Rule 4 is designed to protect client confidences and applies equally to both former and current clients. The court explained that unlike Rule 5, Rule 4 does not contain a prohibition against the use of ethics walls. Accordingly, the Court undertook an analysis of whether the debtor imparted any confidential information to Former Counsel during the active representation, and if any of the matters handled by Former Counsel had a nexus with the Plaintiffs' claims. The court ultimately found that Former Counsel could not represent the Plaintiffs because there was such a nexus. "[I]t appears that an ex-client may disqualify its former counsel from bringing a suit against it which may materially implicate the prior representation."[41]

However, while the court held that Former Counsel, including Mr. Griffith could not represent the Plaintiffs, the court nevertheless found that this was no obstacle to the effectiveness of an ethical wall. Although there is an assumption that upon merger, attorneys from formerly separate firms will share confidences, the assumption is rebuttable. Upon a showing of "specific institutional mechanisms implemented to effectively insulate against the flow of confidentiality from the quarantined attorney to their members of his or her present firm" the presumption would be rebutted.[42]

The court held that the merged firm's handling was sufficient to rebut the presumption, particularly because there were no indications of wrongdoing and denied the debtor's motion to disqualify Plaintiffs' Counsel.

3. Ethical Wall Summary

As mentioned above, the various courts are divided as to whether the use of an ethics wall is sufficient to overcome the presumption that an entire firm should be imputed with the conflict of one of its attorneys and therefore be disqualified from the representation. While generally not a favored practice, the use of ethics walls is necessary in today's legal climate and is allowed by courts in some circumstances.

Practically speaking, the sheer size of many bankruptcy cases requires that debtors be represented by larger firms. Due to the number of creditors involved in these large cases, it is only to be expected that firm attorneys will have some connections with the creditors. Thus, the use of ethics walls in conjunction with the utilization of conflicts counsel in these large cases has been looked upon with favor by some courts. Moreover, many of these large cases remain pending for years. Thus, it is inevitable that the firms will hire new attorneys during the pendency of the cases that either directly or indirectly (by virtue of the representations of their prior firm) have additional connections with the creditors.

While there are no bright line rules for obtaining court approval of the use of ethical walls, at least one circuit has developed a set of factors which must be met in order for an ethical wall to be deemed effective.[43] The Seventh Circuit explained that an ethical wall must include "specific institutional mechanisms" designed to insure the segregation of the tainted attorneys from those performing the work. The Seventh Circuit approved the following mechanisms: (1) denial of access to files or documents relating to the case in question; (2) prohibition of any discussion of the case in the presence of screened attorneys; (3) the disqualified attorneys receive no fees or share of the fees derived from the case; and (4) the screening mechanisms must be established at the time the firm takes the case. At a minimum, these procedures should be immediately implemented to increase the chances of surviving a disqualification motion.

V. Conclusion

It is a legal maxim that a client should be able to choose his or her own attorney. However, as the cases presented clearly demonstrate, the courts, and

[41] *Id.* at 927.
[42] *Id.* at 928.

[43] *See In re Chicago South Shore and South Bend Railroad*, 101 B.R. 10 (Bankr. N.D. Ill. 1989) (discussing the four factor test established by the Seventh Circuit).

especially bankruptcy courts, have the final say. To maneuver the Code and Rules sections dealing with the retention and employment of estate bankruptcy counsel, attorneys must be able to demonstrate, by the various mechanisms detailed above, that the use of conflicts counsel and/or ethical walls will still enable general counsel to ethically and vigorously represent their clients.