Retention of Professionals in Bankruptcy Cases:  
Ethical Issues and Special Considerations

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Retention of Professionals in Bankruptcy Cases: Ethical Issues and Special Considerations

Bankruptcy professionals are subject to the same body of ethical rules that govern non-bankruptcy practitioners in their profession. In addition, ethical considerations for bankruptcy professionals representing a debtor in possession in a case under chapter 11 of the Bankruptcy Code also derive from their client’s statutory responsibilities. The very definition of “conflict” may differ in the bankruptcy context, because various parties’ interests are not always pitted directly against each other, as they generally are under the litigation model on which non-bankruptcy law ethical rules are premised. For instance, while a creditor and a debtor may be “adverse” to each other in the sense that they have differing economic incentives as regards the debt owed, in bankruptcy, both may have the same interest in achieving a successful restructuring of the debtor’s finances. Thus, to determine whether a professional advisor’s connections to a creditor give rise to sufficient “adversity” to disqualify that professional from representing the debtor is not a simple task and requires case-by-case analysis.

Accordingly, analysis of this area of bankruptcy law is highly fact-specific resulting in many hundreds of reported decisions. This outline provides an overview of the general contours of the law regarding the ethical duties of professionals retained to advise and assist the debtor in possession. The cases cited and discussed herein should not be viewed as an exhaustive description of the multiplicity of fact patterns and outcomes in this area of law. Rather, the discussion highlights the central issues and principles involved.

I. SUMMARY OF STATE LAW CONFLICTS OF INTEREST RULES

A. Relevance of State Ethical Rules

State law is the starting point for analyzing conflicts of interest for bankruptcy professionals for two reasons. First, as a threshold matter, all attorneys are bound by the ethical codes or rules in force in the jurisdiction in which they practice law, regardless of the particular type of law they practice. Thus, attorneys have an independent duty — apart from the particular requirements of the Bankruptcy Code or Bankruptcy Rules — to conform their activities to these codes or rules.

In addition, much of the substance of this “state law” is imported into the bankruptcy context by virtue of the fact that the substance of the basic concepts of bankruptcy ethics

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1 11 U.S.C. 101 et seq.

— such as loyalty, independent judgment and even who is considered a client — are drawn from non-bankruptcy law. As will be seen, however, bankruptcy law often sets higher standards for the application of these concepts, reflecting the unique nature of a bankruptcy proceeding. For example, a debtor in bankruptcy is generally not permitted unilaterally to waive its attorneys’ potential conflicts of interest, as it might do outside of bankruptcy. Rather, court approval of the waiver may be required, to insure that it is fair to all parties who hold an interest in the debtor, including its creditors and equityholders.

B. Conflicts Between Two or More Current Clients

1. The Model Code

Under the provisions of the Model Code, an attorney may not accept a representation if “the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected” or the representation “would be likely to involve him in representing differing interests” unless (1) it is “obvious” that the attorney can adequately represent the interests of each client, and (2) each client consents after “full disclosure” of the “possible effect” of such representation on the attorney’s “exercise of independent professional judgment.” DR 5-105(A), (C).

In interpreting the Model Code’s “adversely affect independent professional judgment” test, and the alternative test, “representation of differing interests” tests, courts have concluded that an attorney should be disqualified from representing the newer of the two clients if the facts demonstrate (1) conflicting loyalties which would result in a lack of vigorous representation to either client, or (2) there is a risk of the use of privileged or other confidential information to either client’s detriment. See Damron v. Herzog, 67 F.3d 211, 214 (9th Cir. 1995), cert. denied, 116 S. Ct. 922 (1996); Board of Education v. Nyquist, 590 F.2d 1241 (2d Cir. 1979). See also Picker Int’l, Inc. v. Varian Assoc., 869 F.2d 578 (Fed. Cir. 1989) (conflicting loyalties); Unified Sewerage Agency of Washington County, Oregon v. Jelco, Inc., 646 F.2d 1339 (9th Cir. 1981) (same); Cinema 5 Ltd. v. Cinerama, Inc., 528 F.2d 1384 (2d Cir. 1976) (same); Sumitomo Corp. v. J.P. Morgan & Co., Inc., 2000 WL 145747 (S.D.N.Y. 2000) (adverse affect determined in action where firm was not simultaneously representing adverse clients. Plaintiff had instituted two similar lawsuits against two separate defendants, and had obtained separate counsel for each lawsuit. Complaining client was defendant in second lawsuit, and the firm in question was counsel for plaintiff in first lawsuit); Condren v. Grace, 783 F. Supp. 178 (S.D.N.Y. 1992) (attorney owes a fiduciary duty of loyalty).

References herein to the "Model Code" and "Model Rules" refer to The ABA Model Code of Professional Responsibility and The ABA Model Rules of Professional Conduct, respectively. The two different standards are discussed herein because some states have adopted the former, while others have adopted the latter.
It should be noted that the Model Code provides no qualification for the “adversely affect” test — there is no requirement that the adverse affect be material or substantial when it involves concurrent clients.

Moreover, the law presumes an adverse affect when clients are in adverse positions, although such presumption can be rebutted on specific facts. See Picker Int’l, Inc. v. Varian Assocs., 869 F.2d 578 (Fed. Cir. 1989); Research Corp. Technologies, Inc. v. Hewlett-Packard Co., 936 F. Supp. 697 (D. Ariz. 1996); British Airways, PLC v. Port Authority of New York & New Jersey, 862 F. Supp. 889, 899 (E.D.N.Y. 1994) (“suing one’s [current] client is a dramatic form of disloyalty” warranting disqualification); Shearing v. Allergan, Inc., No. CV-S-93-866-DWH (LRL), 1994 WL 382450 (D. Nev. April 5, 1994) (“No adverse effect need be shown where the adverse position is taken against an existing client; it is presumed.”).


2. The Model Rules

Under the Model Rules, an attorney may not accept a representation if the proposed client is “directly adverse” to an existing client unless (1) the attorney “reasonably believes” that the new representation will not adversely affect the attorney’s relationship with the first client and (2) there is informed consent by both clients after consultation. Model Rule 1.7(a).

Interpretations of the Model Rules’ “direct adversity” test have varied. Most courts have limited the scope of this rule to legal adversity. See Curtis v. Radio Representatives, Inc., 696 F. Supp. 729 (D.D.C. 1988) (law proscribes representation of adverse interests, not adverse clients); see also Kevlik v. Goldstein, 724 F.2d 844, 847-48 (1st Cir. 1984) (firm disqualified by plaintiffs because of prior representation of key witness). But some courts have extended it to bar representations of parties that are economically adverse. See North Star Hotels Corp. v. Mid-City Hotel Assoc., 118 F.R.D. 109 (D. Minn. 1987) (disqualification ordered based on “financial adversity” arising from defendant’s substantial indirect interest in partnerships that were represented by plaintiff’s firm). See also Vegetable Kingdom, Inc. v. Katzen, 653 F. Supp. 917 (N.D.N.Y. 1987) (no conflict if economic interests are not in conflict, even if legal form is technically “adverse”). But see