COUNSEL AS PREFERENCE DEFENDANT
AND CONFLICTS COUNSEL:
THE PROBLEMS POSED BY PILLOWTEX,
ENRON, AND OTHER CASES

For the Panel on

CONFLICTS OF INTEREST AND OTHER
ETHICAL AND FIDUCIARY DUTIES IN CHAPTER 11

JEFF BOHM
McGinnis, Lochridge & Kilgore, L.L.P.
919 Congress Avenue, Suite 1300
Austin, Texas 78701
(512) 495-6000
(512) 495-6093 (Fax)
jbohm@mcginnislaw.com

Written materials:

DAVID. B. YOUNG
McGinnis, Lochridge & Kilgore, L.L.P.
919 Congress Avenue, Suite 1300
Austin, Texas 78701
(512) 495-6000
(512) 495-6093 (Fax)
dyoung@mcginnislaw.com

State Bar of Texas
22ND ANNUAL ADVANCED
BUSINESS BANKRUPTCY COURSE
May 6-7, 2004
Houston

CHAPTER 14.3
# TABLE OF CONTENTS

I. INTRODUCTION .................................................................................................................................................. 1

II. PREFERENCES AND PILLOWTEX .......................................................................................................................... 1
   A. Preferences and Disqualification .......................................................................................................................... 1
   B. The Pillowtex Decision ...................................................................................................................................... 1
   C. The Problems with Pillowtex ............................................................................................................................. 2
   D. Limiting the Scope of the Representation: The Example of Enron .................................................................. 3
   E. Where Pillowtex Does Not Apply: Prepetition Payments for Bankruptcy-Related Services ......................... 4

III. THE ISSUE OF CONFLICTS COUNSEL IN BANKRUPTCY CASES ................................................................. 5
   A. The Use of Conflicts Counsel ............................................................................................................................ 5
   B. The Mechanics and Benefits of the Use of Conflicts Counsel: The Example of Enron ................................. 5
   C. Limitations on the Use of Conflicts Counsel ...................................................................................................... 6
COUNSEL AS PREFERENCE DEFENDANT AND CONFLICTS COUNSEL: THE PROBLEMS POSED BY PILLOWTEX, ENRON, AND OTHER CASES

I. INTRODUCTION

Recent high profile Chapter 11 cases have posed serious problems for debtors’ attorneys and called forth a number of solutions and suggestions for solutions. One issue, by no means new, is whether the receipt of preferential payments or allegedly preferential payments should automatically disqualify a law firm from representing a debtor. The leading case in this regard is In re Pillowtex, Inc., 304 F.3d 246 (3d Cir. 2002), where the Third Circuit held that the bankruptcy court had abused its discretion by allowing a law firm that had received substantial payments from the debtor within 90 days prepetition to serve as the attorney for the debtor-in-possession. Lawyers and commentators have struggled with the implications of Pillowtex and are likely to do so for some time to come.

The second topic is the use of conflicts counsel when the attorneys for a debtor-in-possession or a committee may have a conflict of interest. Nowhere does the Bankruptcy Code expressly provide for the employment of such professionals. Nonetheless, it has become a device used with greater frequency in mega-cases when only a few large firms are capable of handling the complex tasks involved. Surprisingly, there has been relatively little discussion of conflicts counsel in reported opinions. The most cogent discussion of conflicts counsel appears to be Judge Arthur Gonzalez’s opinion in In re Enron Corp., No. 01-16034 (AJG), 2002 WL 32034346 (Bankr. W.D. Mich. 1999). The Office of the United States Trustee has taken a very dim view of a debtor’s law firm demanding that its accounts be brought current shortly before a bankruptcy filing. Joseph A. Guzinski, Yet Another View of In re Pillowtex, 849 PLI/COMM 1379 (2003). A showdown over this issue came in In re Pillowtex, Inc., 304 F.3d 246 (3d Cir. 2002).

II. PREFERENCES AND PILLOWTEX

A. Preferences and Disqualification.

Under 11 U.S.C. § 327(a), an attorney for a trustee or a debtor-in-possession must be a “disinterested person” and must not “hold or represent an interest adverse to the estate.” A creditor — the holder of a prepetition claim — is not disinterested, 11 U.S.C. § 101(14)(A), and, at least arguably, holds an interest adverse to the estate. See id. § 101(14)(E). Hence, an attorney or law firm with a prepetition claim against the debtor for unpaid fees could not qualify to represent a debtor-in-possession under Section 327(a). As a result, it is commonplace for attorneys with unpaid prepetition fees to waive — or to be compelled to waive — any right to be paid for their prepetition services as the price of becoming counsel for the estate. See, e.g., In re Princeton Medical Mgmt., Inc., 249 B.R. 813 (Bankr. M.D. Fla. 2000); In re Fulgham Enters., Inc., 181 B.R. 139 (Bankr. N.D. Ala. 1995); In re Watervliet Paper Co., Inc., 96 B.R. 768 (Bankr. W.D. Mich. 1989).

In order to avoid the Scylla of being forced to forego any claim to prepetition fees, some firms have demanded the full payment of outstanding bills before the debtor files its petition. See Thomas J. Salerno & Jordan A. Kroop, Revisiting Retentions for Professional Preferences, 21-Jan. AM. BANKR. INST. J. 34 (2003); see also Arnold M. Quittner, Employment and Compensation of Professionals, 863 PLI/COMM 145 (2004). The difficulty is that this practice runs the risk of sending the attorney or law firm hurtling toward the Charybdis of being a preference defendant. If a payment within 90 days of the petition date — or within one year if the law firm is deemed an insider — were set aside, then the would-be counsel for the estate would have a claim for the pro rata share that would be paid to other unsecured creditors. In other words, the attorney or law firm would be a creditor once again and thus disqualified. The receipt of an avoidable preference could amount to a bar to serving as counsel for the debtor-in-possession. In re First Jersey Securities, Inc., 180 F.3d 504 (3d Cir. 1999). For several years, Jones, Day Reavis & Pogue had served as the principal law firm for Pillowtex, Inc., giving legal advice and performing legal services in a wide variety of fields. As the financial difficulties of Pillowtex worsened, Jones, Day sought payment for its unpaid fees. Pillowtex filed a Chapter 11 petition in Delaware in November, 2000. Within 90 days before the filing, Pillowtex had brought its account current by paying Jones, Day $997,569.36. The largest single payment was $778,157.33. In addition, Pillowtex had given Jones, Day a $300,000 retainer for services performed or to be performed in connection with the impending bankruptcy. Approximately $100,000 had been applied toward prepetition bankruptcy-related fees.

The United States Trustee objected to the retention of Jones, Day as counsel for the debtor-in-possession, arguing that Jones, Day had received what facially appeared to be a substantial preference. Thus, Jones, Day was not disinterested as 11 U.S.C. § 327(a) requires, and Jones, Day at least arguably held an
interest adverse to the estate and to other creditors. Jones, Day maintained that the payments were not in fact preferential because they had been made in the ordinary course of business. 11 U.S.C. § 547(c)(2). If the payments were later determined to be preferential, however, Jones, Day offered to return them and waive any claim against the estate. See Bruce H. White & William L. Medford, Disinterestedness and Preferential Transfers: Can’t We Talk About This Later?, 21-Jan. ADM. BANKR. INST. J. 38 (2003). The bankruptcy court approved the retention of Jones, Day on these terms notwithstanding the objections of the United States Trustee. The United States Trustee appealed to the district court, which affirmed, and then to the Third Circuit.

In the first decision at the court of appeals level to address this issue, the Third Circuit reversed the lower courts and sided with the Office of the United States Trustee. In re Pillowtex, Inc., 304 F.3d 246 (3d Cir. 2002). The court of appeals pointed out that, at least facially, Jones, Day had received a substantial preference, and that this, without more, would be enough to disqualify the firm under 11 U.S.C. § 327(a). The offer to return the preference in the future would do no good.

The underlying theme in the Third Circuit’s opinion was that Jones, Day would be in a position of litigating on its own behalf against the estate if anyone were ever to bring an avoidance action for the estate. In most jurisdictions, a creditors’ committee, or even an individual creditor, may bring an avoidance action derivatively with the bankruptcy court’s consent if the debtor-in-possession or the trustee has unjustifiably failed or refused to do so. Louisiana World Exposition v. Federal Ins. Co., 858 F.2d 233 (5th Cir. 1988); accord In re Perkins, 902 F.2d 1254 (7th Cir. 1990); In re STN Enters., Inc., 779 F.2d 901 (2d Cir. 1985); In re Automated Bus. Sys., Inc., 642 F.2d 200 (6th Cir. 1981). After an aberrational panel decision, the Third Circuit en banc has joined other courts in this respect. Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548 (3d Cir.) (en banc), cert. dismissed, 124 S. Ct. 530 (2003). The classic scenario of a derivative avoidance action involves a suit against the debtor’s principals; the debtor could scarcely be expected to sue its own officers or directors, and so a creditor or committee must do so. In Pillowtex, by contrast, the debtor would have had no problem with suing Jones, Day; the debtor’s law firm would have had a problem suing itself. No matter who prosecuted the action, Jones, Day would have been adverse to the estate that it was supposed to represent.

The Third Circuit was not unsympathetic to Jones, Day’s predicament, and the court of appeals did not render judgment that Jones, Day should be disqualified. Rather, the Third Circuit pointed out that it had not been conclusively determined whether Jones, Day had in fact received a preference. The mere possibility that the payments might have been preferential was not enough to create a disabbling conflict. Pillowtex, 304 F.3d at 246. Accordingly, the Third Circuit remanded the case to the bankruptcy court for a determination as to whether the prepetition payments actually were avoidable and whether Jones, Day had a meritorious affirmative defense.

Apparently, the Third Circuit did not mean to say that the United States Trustee had standing or could acquire standing to prosecute an avoidance action as such. The consequence of finding that the payments were preferential would not have been avoidance, but rather the disqualification of Jones, Day, and thus the possible denial of compensation for the extensive work already done in the bankruptcy case. Of course, any such determination would have been preclusive in a later suit for avoidance and recovery under 11 U.S.C. §§ 547, 550.

C. The Problems with Pillowtex.

The difficulties with In re Pillowtex, Inc., 304 F.3d 246 (3d Cir. 2002) are obvious enough for a law firm that wishes to represent a Chapter 11 debtor. There is the dilemma of waiving unpaid prepetition fees as the price of obtaining employment as the debtor’s counsel, or, in the alternative, demanding payment prepetition and risking the possibility of disqualification as a preference defendant. Although the Third Circuit acknowledged the right of debtor’s counsel to be paid for its work, the court offered little in the way of a solution.

Another problem is the difficulty for the estate rather than for the attorneys. A literal reading of Pillowtex would indicate that the preference question must be resolved before the employment of counsel is approved; to postpone the matter as the case goes on would be to run the risk of the forfeiture of all or part of the fees if counsel is ultimately determined to have had a conflict. Because a creditors’ committee is rarely ready to operate at the outset of a case, presumably the United States Trustee and the firm seeking to be the debtor’s attorney would have to litigate the issue for some time before employment could be approved. Meanwhile, the estate would have serious legal business on which counsel would have to be engaged. Critical first day orders would have to be obtained; DIP financing would have to be arranged; there would have to be orders approving the use of cash collateral. Unless the debtor’s attorneys could devote their full energies to such matters at once, the estate could slide into chaos. Creditors as well as the debtor could be prejudiced if the retention of counsel were delayed pending the resolution of a preference

Various solutions have been proposed, but most of them are not satisfactory. Obviously the *Pillowtex* problem would be moot if the estate is solvent and all creditors will be paid in full. Bankruptcy avoiding powers may be used only for the benefit of creditors, not for the benefit of the debtor or its equity owners. *In re Kennedy Inn Assocs.*, 221 B.R. 704 (Bankr. S.D.N.Y. 1998); *In re Best Prods. Co.*, 158 B.R. 35 (Bankr. S.D.N.Y. 1994), appeal dismissed, 177 B.R. 791 (S.D.N.Y.), appeal reinstated and aff'd, 68 F.3d 26 (2d Cir. 1995). Thus, if an estate is solvent and creditors will be paid in full, there can be no avoidability under a preference theory or otherwise. *In re Board of Directors of Hopewell Intern. Ins. Co.*, 238 B.R. 25 (Bankr. S.D.N.Y. 1999), aff'd, 275 B.R. 699 (S.D.N.Y. 2002). The difficulty is that this situation is extremely rare. Few law firms could snap their fingers at *Pillowtex* because they are fortunate enough to represent a solvent debtor-in-possession. See David B. Young, *Preferences and Fraudulent Transfers*, 861 PLI/COMM 637 (2004).

It has also been suggested that, after full disclosure, a law firm could place the allegedly preferential prepetition payments in escrow at the outset of the case pending a later determination as to whether they were avoidable. Susan M. Freeman, *Current Issues in Bankruptcy Ethics*, 091803 ABI-CLE 265 (Sept. 2003). Although this might be a step in the right direction, it would not circumvent the problem that the law firm would be litigating against its own client as to who was entitled to the escrowed funds. There would still be a rather blatant conflict of interest.

Finally, some commentators have proposed that law firms should be proactive and never allow the accounts of a financially troubled client to fall into arrears. Furthermore, if the client is sliding into bankruptcy, a law firm should demand a sizeable retainer and not permit unbillable fees and expenses to fall below the amount of the retainer. Jonathan P. Friedland & Sven T. Nyland, *Accounts Receivable and Retainer Management: Lessons from Pillowtex*, 21-Jan. Am. Bankr. Inst. J. 16 (2003). Conceivably, this might work, but it would place the law firm in the position of pressuring a financially troubled client for its own benefit. Such advice smacks of the unsavory notion that the bankruptcy system is a complex game that professionals should play for their own benefit. Beccaria’s words are apposite: “[S]o, sometimes with despotic impatience, sometimes with effeminate timidity, they have transformed serious [adjudications] into a kind of game in which chance and subterfuge are the chief elements.” CESARE BECCARIA, *ON CRIMES AND PUNISHMENTS*, ch. XIII at 24 (David B. Young ed. & trans. 1986).

**D. Limiting the Scope of the Representation: The Example of Enron.**

An interesting and instructive contrast to *In re Pillowtex*, Inc., 304 F.3d 246 (3d Cir. 2002) is provided by Judge Arthur Gonzalez’s decision in *In re Enron Corp.*, No. 01-16034 (AJG), 2002 WL 32034346 (Bankr. S.D.N.Y. May 23, 2002), aff’d, No. 02-Civ.-5638 (BSJ), 2003 WL 22435 (S.D.N.Y. Feb. 3, 2003). In *Enron*, a creditor moved to disqualify Milbank, Tweed, Hadley & McCloy, LLP as counsel for the official unsecured creditors’ committee because, among other reasons, Milbank, Tweed had received allegedly avoidable preferences from some of the debtor entities. Unlike Jones, Day, the attorneys for a debtor-in-possession appointed under 11 U.S.C. §327(a), Milbank, Tweed had been employed as counsel for a committee under 11 U.S.C. § 1103(b). Unlike Section 327(a), Section 1103(b) does not expressly require a committee’s professionals not to hold or represent an interest adverse to the estate. Nonetheless, 11 U.S.C. § 328(c) permits a bankruptcy court to deny compensation to any professional, including a committee’s attorneys, if the professional holds or represents an interest adverse to the estate. Thus, the standards of Section 327(a) have been held relevant, and, to some extent, incorporated into the employment and retention of counsel for a committee under Section 1103(b). See *In re Caldor, Inc.*, 193 B.R. 165 (Bankr. S.D.N.Y. 1996). Judge Gonzalez in *Enron* assumed that the receipt of a preference could disqualify a committee’s law firm just as it could disqualify the lawyers for a debtor-in-possession.

Judge Gonzalez declined to hold that Milbank, Tweed was disqualified, however, even on the assumption that the prepetition payments were preferential. First, Milbank, Tweed had very carefully limited the scope of its representation and, with the consent of the sophisticated committee members, had been appointed on the understanding that it would not represent the committee on any matter with respect to which Milbank, Tweed had a conflict. Thus, Milbank, Tweed would never be in the position of litigating against its client concerning a matter on which Milbank, Tweed represented the client. Second, unlike Jones, Day in *Pillowtex*, Milbank, Tweed had agreed not to litigate the preference issue at all. Third, the bankruptcy court had appointed an examiner, Neal Batson. Mr. Batson was an impartial third party. Milbank, Tweed had agreed to be bound by the examiner’s investigation and to repay promptly any prepetition payment that Mr. Batson and his staff
deemed preferential. Under these circumstances, Judge Gonzalez concluded that the allegedly
preferential payments did not create a conflict, and that
there was no reason to disqualify Milbank, Tweed on
this basis. In re Enron, 2002 WL 32034346.

The agreement not to litigate and to be bound by
the recommendation of a neutral third party appears to
be the best solution thus far to the preference problem.
See Jonathan P. Friedland & Sven T. Nylen, Accounts
examiner with broad-ranging duties such as Mr. Batson
may be justifiable only in very large cases. On the
other hand, the appointment of a neutral party to
examine prepetition transactions and an agreement to
surrender any payments found to be preferential is
no different in principle from waiving unpaid prepetition fees. Appointing an examiner for a limited purpose is
certainly authorized, 11 U.S.C. § 1104(c), and it might
not be excessively burdensome or costly in smaller
cases. Such a procedure might resolve many problems
quite efficiently. The Enron opinion will be discussed
more fully below in connection with conflicts counsel.
Here, however, the contrast between the course
pursued by Jones, Day and by Milbank, Tweed should
provide worthwhile lessons.

E. Where Pillowtex Does Not Apply: Prepetition Payments for Bankruptcy-Related Services.

A noteworthy feature of In re Pillowtex, Inc., 304
F. 3d 246 (3d Cir. 2002) and In re Enron Corp., No. 01-
16034 (AGJ), 2002 WL 32034346 (Bankr. S.D.N.Y.
May 23, 2002), aff’d, No. 02-Civ.-5638 (BSJ), 2003
WL 22435 (S.D.N.Y. Feb. 3, 2003), was that both of
these cases involved the payment of prepetition fees
for services unrelated to preparation for bankruptcy.
Indeed, in Pillowtex, the United States Trustee
specifically disclaimed any argument that the fees that
Jones, Day had received for prepetition bankruptcy
work could or should be avoided. The Pillowtex
situation and, for that matter, the problems presented in
Enron should be carefully distinguished from cases
where the debtor’s attorney has received prepetition payments for bankruptcy-related work. In such cases,
Pillowtex does not apply at all.

Prepetition fees paid to a debtor’s attorney for
services rendered in connection with or in
contemplation of the bankruptcy case are not
preferences or fraudulent transfers, and they are not
subject to avoidance under 11 U.S.C. §§ 544, 547
and/or 548. Such payments are recoverable, if at all,
In re Dixon, 143 B.R. 671 (Bankr. N.D. Tex. 1992); see In re Hargis, 895 F. 2d 1025 (5th Cir. 1990). Most
important, the receipt of prepetition payments for legal
work in connection with or in contemplation of the
bankruptcy case does not create a conflict of interest or
disqualify the attorney or law firm from representing
the debtor. In re Creative Restaurant Mgmt., Inc., 139
B.R. 902 (Bankr. W.D. Mo. 1992); Ilana Kameros
Chalfin, Note, Retaining the Debtor’s Attorney: Preemption of Voidable Preference Law by Section

Under the Bankruptcy Act, it was firmly
established that, if a debtor made prepetition payments
to an attorney to give advice in extricating the debtor
from financial difficulty or to prepare for bankruptcy,
the payments were not subject to attack as preferences
or fraudulent conveyances, and they did not create a
conflict of interest. Rather, under Section 60(d) of the
Bankruptcy Act, the predecessor of the current 11
U.S.C. § 329, such payments could be set aside only to
the extent that they were unreasonable or excessive.
Quinn v. Union Nat’l Bank of Rochester, Minn., 32
F. 2d 762 (8th Cir. 1929); accord In re Wood, 210 U.S.
246 (1908). The enactment of the Bankruptcy Code
and the current Bankruptcy Rules changed nothing in
this respect. Dixon, 143 B.R. at 671; accord In re
1988).

All prepetition attorney fees paid “in
contemplation of or in connection with” the bankruptcy
case fall within the ambit of Section 329 and Rule
2017 and are completely outside the scope of the
normal avoidance powers. Chalfin, Note, Retaining
the Debtor’s Attorney, 25 CARDOZO L. REV. at 863.
This criterion of payment in contemplation of or in
connection with the bankruptcy has always been
broadly construed. Conrad, Rubin & Lesser v. Pender,
289 U.S. 472 (1933). If the payments fall within this
capacious category, they may be recovered, if at all,
only to the extent that they were unreasonable or
excessive. See In re Lee, 884 F. 2d 897 (5th Cir. 1989).
If the prepetition bankruptcy-related fees were not
unreasonable or excessive, then there is no basis for
attacking them. In re Emco Enter., Inc., 94 B.R. 184
(Bankr. E.D. Cal. 1988). Even if a portion of the
prepetition bankruptcy-related fees must be disgorged
as unreasonable or excessive, this, without more, does
not create a conflict of interest, and it does not, standing alone, disqualify the attorney or law firm from
continuing to represent the debtor or from receiving
reasonable compensation for postpetition services.
Creative Restaurant Mgmt., 139 B.R. at 902.

Thus, the issues raised by Pillowtex should not be
carried beyond their proper sphere. Under no
circumstances should an attorney or law firm be
disqualified under 11 U.S.C. § 327(a) because of
prepetition payments for work done in connection with
or in preparation for the subsequent bankruptcy.

"Counsel As Preference Defendant And Conflicts Counsel: The Problems Posed By Pillowtex, Enron, And Other Cases" Chapter 14.3
III. THE ISSUE OF CONFLICTS COUNSEL IN BANKRUPTCY CASES

A. The Use of Conflicts Counsel.

The use of attorneys known as “conflicts counsel” is nothing new. For example, when a public defender’s office would face a conflict of interest in representing two criminal defendants each of whom might wish to save himself by inculpating the other, it is common to hire outside conflicts counsel to represent one of the defendants, or even to use a special bureau or department of conflicts counsel within the public defender system. E.g., People v. Christian, 48 Cal. Rptr. 2d 867 (Cal. App. 1996); Ethics Opinion 960924: Is This Office Sharing Arrangement an Ethical No-No?, 22-Dec. MONT. LAW. 9 (1996). Such arrangements are entirely proper and have been upheld consistently when adequate safeguards and “cones of silence” are placed around the conflicts attorneys. MONT. ETH. OP. 960924 (Dec. 1996); see also PA. INFORMAL ETH. OP. 92-139 (Oct. 6, 1992).

In bankruptcy, it is common enough for a creditors’ committee and its attorneys, or an individual creditor and its attorney, to seek and obtain derivative standing to sue on behalf of the estate when the trustee or debtor-in-possession cannot or will not act. E.g., Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548 (3d Cir.) (en banc) (giving an exhaustive and thorough analysis), cert. dismissed, 124 S. Ct. 530 (2003); In re Perkins, 902 F.2d 1254 (7th Cir. 1990); Louisiana World Exposition v. Federal Ins. Co., 858 F.2d 233 (5th Cir. 1988); In re STN Enters., Inc., 779 F.2d 901 (2d Cir. 1985); In re Automated Bus. Sys., Inc., 642 F.2d 200 (6th Cir. 1981). The most common scenario for such a step is an action against the debtor’s principals that the debtor obviously will not pursue on its own. A derivative suit for the estate could also be appropriate, however, when the law firm representing the debtor or the trustee might have an actual or potential conflict of interest in suing a present or former client on behalf of the estate, even though the law firm might have had nothing to do with the transaction at issue and would not be disqualified from representing the debtor generally. In such instances, particularly in the latter sort of case, one might speak of the attorneys for the committee or for the individual creditor as “conflicts counsel.”

The use of conflicts counsel in its more recent sense, however, has involved mega-cases where the resources of large firms are needed to represent the debtor and committees. In such instances, the firm itself may be a defendant in some actions or else closely linked to a party who will be a defendant. Large firms in high profile cases often bring a great deal of baggage with them. To insist that the debtor or the committee be represented only by one firm with no actual or potential conflicts could effectively deprive the debtor or the committee of counsel, or at least of effective counsel. Thus, the practice has grown of engaging two sets of attorneys for a debtor or a committee: the primary counsel and conflicts counsel to represent the committee or the debtor-in-possession when the lead attorneys have a conflict of interest or might themselves be the defendants. Michael P. Richman, Mega-Case Conflict Issues: Enron Committee Counsel, 21-Sep. AM. BANKR. INST. J. 20 (2002); see Bruce H. White & William L. Medford, The Adequacy of Disclosures—Avoiding Even the Appearance of Impropriety, 23-Feb. AM. BANKR. INST. J. 20 (2004). For instance, in the Global Crossing case, the unsecured creditors’ committee was represented by Brown Rudnick Berlack Israels, LLP, while Greenberg Traurig, LLP served as conflicts counsel on those matters where Brown Rudnick could not properly act. See In re Global Crossing Ltd., 295 B.R. 726 (Bankr. S.D.N.Y. 2003). Likewise, in the Enron case, Milbank, Tweed, Hadley & McCloy, LLP served as counsel for the creditors’ committee, while Squire Sanders & Dempsey LLP served as conflicts counsel. See In re Enron Corp., 279 B.R. 671 (Bankr. S.D.N.Y. 2002).

B. The Mechanics and Benefits of the Use of Conflicts Counsel: The Example of Enron.

The most thorough judicial discussions of the use of conflicts counsel and the mechanics of using this device are the bankruptcy court and the district court opinions in In re Enron Corp., No. 01-16034 (AJG), 2002 WL 32034346 (Bankr. S.D.N.Y. May 23, 2002), aff’d, No. 02-Civ.-5638 (BSJ), 2003 WL 223455 (S.D.N.Y. Feb. 3, 2003). There, a creditor sought to disqualify Milbank, Tweed from serving as counsel for the 14-member unsecured creditors’ committee. There were numerous allegations of actual or potential conflicts. Two of the 14 members of the committee were significant clients of Milbank, Tweed and potential defendants in various actions. Milbank, Tweed represented many other creditors, albeit in matters unrelated to the bankruptcy. Milbank, Tweed had represented certain institutions that had arranged for a billion dollar structured finance offering on behalf of an Enron affiliate. In the years prior to the Chapter 11 case, Milbank, Tweed had represented some of the debtors in more than a hundred transactions and had collected more than $18 million in fees for this work. In addition, Milbank, Tweed had received roughly $500,000 in allegedly preferential transfers from the debtors within 90 days prepetition. See Richman, Mega-Case Conflict Issues, 21-Sep. AM. BANKR. INST. J. at 20.

The motion to disqualify was rejected on a variety of grounds. For one thing, the creditor had delayed for
several months in prosecuting its motion to disqualify. The inconsistency between the urgency of the movant’s arguments and the lackadaisical fashion in which it had pursued them, in the bankruptcy court’s view, was sufficient in itself to deny the motion. Furthermore, as previously discussed, the bankruptcy court had appointed an examiner, Neal Batson. Milbank, Tweed had agreed to be bound by the examiner’s report and to return any prepetition payments that were deemed preferential.

Three considerations, however, tipped the balance decisively in Milbank, Tweed’s favor. First, when it first sought employment, Milbank, Tweed had disclosed its connections with the debtors and with all creditors in painstaking detail. The bankruptcy court rejected any suggestion that the disclosures were inadequate. Milbank, Tweed was under no obligation to discuss every inference that might be drawn from the connections that it revealed or to anticipate all possible future litigation or its outcome. See White & Medford, The Adequacy of Disclosures, 23-Feb. AM. BANKR. INST. J. at 20.

Second, Milbank, Tweed had carefully limited the scope of its representation to matters where there was no conflict. With respect to the matters at issue, Milbank, Tweed was not the law firm for the committee. The sophisticated members of the committee had given their informed consent after consultation. This sort of limitation of the scope of representation is supported by ethical rules such as ABA Model Rule of Professional Conduct 1.2(c). See TEX. DISCIPLINARY R. PROF. CONDUCT 1.02(b); N.Y.C. FORMAL ETH. OP. 2001-3 (July 6, 2001). It is supported by the American Law Institute. RESTATEMENT OF THE LAW GOVERNING LAWYERS § 121, cmt. c(iii) (2000). Above all, such a limitation on the scope of representation has support in decisional law. See Interstate Properties v. Pyramid Co. of Utica, 547 F. Supp. 178 (S.D.N.Y. 1982). This includes bankruptcy decisions. See In re H&S Transp. Co., Inc., 53 B.R. 128 (Bankr. M.D. Tenn. 1985) (law firm appointed by trustee to represent four jointly administered estates was entitled to compensation where firm had represented the trustee only to the extent that the interests of the four estates were parallel or congruent).

Third, Squire Sanders had been retained as conflicts counsel to represent the committee where Milbank, Tweed would not be able to do so. Thus, the committee would not be left in the lurch by a precipitous or unanticipated withdrawal. In fact, the committee completely approved of Milbank, Tweed’s representation, and Square Sanders had prepared the committee’s response to the motion to disqualify.

In light of the thorough disclosure, the careful and informed consent to the limitation on representation, and the use of conflicts counsel from the outset, both the bankruptcy court and the district court determined that Milbank, Tweed had not breached and was not likely to breach any duty to the creditors’ committee or its constituents. Although there could be some differences, the same basic principles should apply to selecting the principal counsel and conflicts counsel for a debtor-in-possession. See White & Medford, The Adequacy of Disclosures, 23-Feb. AM. BANKR. INST. J. at 20.

C. Limitations on the Use of Conflicts Counsel.


At the same time, there are limitations on the use of conflicts counsel. Of necessity, this device will usually be limited to large cases. In small and mid-sized bankruptcies, it would normally be difficult to make the argument that there are few firms with the skill and the resources to do the job, and thus that a firm with significant conflicts problems must of necessity be the principal counsel for the debtor or a committee. Michael P. Richman, Mega-Case Conflict Issues: Enron Committee Counsel, 21-Sep. AM. BANKR. INST. J. 20 (2002). Furthermore, the employment of two law firms is expensive and may eat into the funds that would otherwise go to creditors. Finally, although the use of conflicts counsel may be necessary and appropriate in some instances, it might not necessarily avoid all impropriety, or at least the appearance of impropriety, and the suspicion that major law firms are scratching one another’s backs as well as the backs of their various clients. See Charles J. Tabb, The Enron Bankruptcy, in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 301, 322-26 (Nancy B. Rapoport and Bala G. Dharan eds. 2004).