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Third Circuit Rejects Side-Switching Disqualification Claim

By Michael L. Cook

The Third Circuit recently affirmed the bankruptcy court's approved retention of the debtor's counsel ("S") when that "law firm dropped an existing client to avoid conflicts that would prevent it from taking on a more lucrative client [i.e., the debtor]." *In re Boy Scouts of America*, 2022 WL 1634643, *7 (3d Cir. May 24, 2022) (*BSA*). According to the court, there were "not enough facts to put [the so-called "hot potato" doctrine] into play" and disqualify S under the Rules of Professional Conduct. *Id*. Moreover, because S's representation of the debtor "did not prejudice [the objecting former client], but disqualifying [S] would have been a significant detriment to [the debtor], it was well within the [bankruptcy] court's discretion to determine that the drastic remedy of disqualification was unnecessary." *Id*. Particular facts of the case, highlighted by the court, supported its finding that there was "nowhere close to an abuse of discretion" by the bankruptcy court's applying Bankruptcy Code (Code) §327(a) to approve S's retention.

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Relevance

Conflicts of interest among clients are a chronic problem for law firms with many clients. How law firms address the problem — and they must — is what the *BSA* decision shows. The decision also shows the problems law firms have in balancing their ethical obligations against the desire for more business. In *BSA*, S was held to have acted properly, but one client still felt "jilted," if not betrayed. *Id*. at *1.

Facts

S had represented an insurer ("C") "in obtaining backup coverage from reinsurers of [C's] policies." *Id*. at *1. S "also represented the [debtor] in its restructuring efforts under the… Code…." *Id*. The debtor "made coverage claims under [C's] policies, [but] did so while represented by another firm ["H"]," excluding S from that work. S's "reinsurance services for [C] were limited to claims made against the reinsurers (and not [the debtor])." "That representation did not extend to the underlying direct insurance issued by [C] to [the debtor]." *Id*. Still, C "claimed a conflict concerning [S's] representation of it [and the debtor]," objecting to the debtor's motion to retain S in the bankruptcy court. C's objection "only concerned the ability of [S] to represent [the debtor]," but the bankruptcy court found that S "could do so effectively" after approving S's retention.

Bankruptcy Court Discretion

First, reasoned the Third Circuit, "bankruptcy courts have 'considerable discretion in evaluating whether professionals suffer from conflicts.'" *Id*. at *4, quoting *In re Pillowtex, Inc.*, 304 F.3d 246, 254 (3d Cir. 2002). "Courts thus proceed 'case-by-case'." "Pragmatically, a conflict is actual when the specific facts before the bankruptcy court suggest … 'that a professional will [likely] be placed in a position permitting it to favor one interest over an impermissibly conflicting interest.'" *Id*.

Limited Role of Rules Of Professional Conduct

C argued that the bankruptcy court should have considered applicable Rules of Professional

Conduct before reaching a conclusion on S's retention under Code §327, relying on *In re Congoleum Corp.*, 426 F.3d 675, 687-92 (3d Cir. 2005). The court conceded that professional conduct rules "may be relevant and 'consulted when they are compatible with federal law and policy,' but a bankruptcy court "may not need to examine the relevant professional rules to decide a §327 retention." *Id*. at *5. Because the asserted conflict here did not implicate "the economic interests of the estate," it "was outside the scope of §327(a)." *Id*. *But see, Congoleum*, 426 F.3d at 687 ("Bankruptcy professionals are required to examine their relationship not only on the two-party litigation model, but also are guided by 'a stricter, fiduciary standard.'"), quoting 1 Collier, *Bankruptcy* 8.01[1] (15th rev. ed.).

C never effectively challenged the bankruptcy court's finding that S had no "interest adverse to the estate." *Id*. Even if the asserted conflict had violated the rules of Professional Conduct, this violation did not impair S's "effective representation of [the debtor] for purposes of §327(a)." In fact, another firm, H, had "served as [the debtor's] dedicated insurance counsel at all relevant times, and [the debtor] was not a party to the reinsurance matters" that S worked on for C. C also failed to explain why "its positions in the reinsurance disputes are opposed to [the debtor's] interests during its reorganization." *Id*. S's "relationship to [C] did not affect its ability to advocate on behalf of [the debtor]," said the court, meaning there was no "actual conflict" under Code §327. *Id*. In any event, C was "separately pursuing its grievances about" S's conduct "in arbitration" under "their governing retention agreement." *Id*. at *2. As the court noted, "the putative conflict was outside the purview of §327(a)." *Id*. at *5 n.5

The court stressed that "violations of the Rules of Professional Conduct are [not always] themselves sufficient to create a §327 conflict …. Here … [S] represented [C] in reinsurance matters in which [the debtor] was not a party, and [S's] representation of [the debtor] excluded insurance issues." *Id*. at *6.

No Mandatory Disqualification

Moreover, reasoned the court, "the power to disqualify stems from a court's authority to supervise the attorneys appearing before it," and a decision to use that power "is discretionary and 'never is automatic.'" *Id*. at *7, quoting *United States v. Miller*, 624 F.2d 1198, 1201 (3d Cir. 1980). Courts in the Third Circuit "often deny disqualification even when finding or assuming conflicts under the professional conduct rules." *Id*. at *7. Although the bankruptcy court here did not "definitively decide whether" S had violated any professional responsibility rules, C "could not have been adversely affected … because [S's] bankruptcy team did not receive any confidential or privileged information from the attorneys working on [C's] reinsurance matters." *Id*. S, in fact, had imposed "a formal ethics screen … between its restructuring team and its reinsurance team." *Id*. at *2. Disqualifying S, therefore, reasoned the court, "would have been a significant detriment to" the debtor. *Id*.

Comments

1. The Third Circuit's careful, nuanced factual analysis helped S avoid disqualification. But the decision could have been different with a less persuasive fact pattern. *See*, *e.g.*, *In re Filene's Basement*, 239 B.R. 850, 858 (Bankr. D. Mass. 1999) (side-switching firm removed and ordered to return retainer; debtor's law firm "failed fully to disclose its connection with [debtor's litigation targets] as required by Rule 2014."); *In re Congoleum*, 426 F.3d 675, 692 (3d Cir. 2005) (held, simultaneous representation of debtor as special insurance counsel and over 10,000 asbestos personal injury claimants, as well as ownership interest in screening company hired by debtor to evaluate claims, "represent factors which prevent [firm] from being completely loyal to [debtor's] interests."; moreover, "waivers under §327(a) are ordinarily not effective."); *In re Project Orange Assocs., LLC*, 431 B.R. 363 (Bankr. S.D.N.Y. 2010) (Multinational law firm seeking appointment as debtor's general bankruptcy counsel could not contractually circumvent statutory requirements of §327 by means of a conflict waiver and conflicts counsel when it had represented debtor's largest unsecured creditor; unsecured creditor's participation was necessary for a successful reorganization of the debtor; moreover, conflict waiver agreement impaired the firm's ability to act in the best interest of the debtor because it barred the firm from suing the unsecured creditor); *Chugach Elec. Ass'n v. United States Dist. Court*, 370 F.2d 441 (9th Cir. 1966) (counsel who brought antitrust suit

against former employer ordered disqualified); *see also*, *Sullivan County*, 686 A.2d 755, 758 (N.H. 1996) ("[A]n attorney owes a duty of loyalty to a former client that prevents that attorney from attacking, or interpreting, work she performed, or supervised, for the former client."); *In re AFI Holdings, Inc.*, 530 F.3d 832, 850 (9th Cir. 2008) (trustee had "materially adverse" interest due to, among other factors, her prior representation of debtor's insider, and this adverse interest warranted her removal); *Milbank, Tweed v. Chan*, 13 F.3d 537 (2d Cir. 1994) (former counsel for prospective bidder at judicial sale of debtor's assets not permitted to represent another competing bidder).

2. The Third Circuit recently heard oral argument in another provocative case dealing with the lateral movement of partners between opposing law firms. *In re Maxus Energy Corp.*, 626 B.R. 249 (Bankr. D. Del. 2021) (lateral movement of partner between firms; moving lawyer with confidential information switched to firm representing litigation adversary of former client; no disqualification because of new firm's adequate screening process; marriage to partner in new firm also not relevant; Fed. R. Evid. 404(a)(i) bars inference that new partner would violate ethical screen). According to reports of the oral argument, the Third Circuit was favorably impressed by the new firm's screening process. The record showed the moving partner: a) disclosed nothing to the new firm; and b) would not share in the fees received by the new firm from the pending litigation. According to the objecting client, however, the moving partner spent 300 hours on its case, helped with strategy, and worked on a dispositive motion. The bankruptcy court conceded that the moving attorney "was privy to client confidences, and [her former client's] strategy and tactics … [as] one of the senior attorneys" in the litigation while "dating" and cohabitating with the head of the opposing firm's restructuring group during the litigation. It rejected those facts, though, as "a shabby attempt" to embarrass the two lawyers who later married. *Id.* at 261.

3. The S "attorneys working for [the debtor] moved to a new firm, taking with them [the debtor] as a client" almost two years before the Third Circuit rendered its decision. 2022 WL 1634643, at *2. Because of "the possibility … that [the court] could order the disgorgement of [S's] fees," the "matter" was held "not moot." *Id.* at *4.

4. *BSA* may properly represent the state of applicable law under Code §327. But lawyers face a serious practical dilemma: how to deal with what the Third Circuit called the "jilted" client. *BSA*, 2022 WL 1634643 at *1. The court recognized that the reorganizing debtor would have sustained a "significant detriment" if it lost its chosen, experienced counsel. *Id.* at *7. C's reaction to being "dropped" by S for a more profitable engagement, however, was rejected by the district court: Code §327 "is not intended to vindicate the rights of third parties." 630 B.R. 122, 137 (D. Del. 2021). We could tell C to "get over it", but the provocative facts of *BSA* and *Maxus Energy* may never convince the non-lawyer public that lawyers subordinate their personal interests to those of their clients. The disqualification claims in *BSA* and *Maxus Energy* were hardly frivolous and were made by highly respected lawyers on behalf of their aggrieved clients.

It may be time now for lawyers to rebalance the bankruptcy process to accommodate the interests of all their clients. As the Fifth Circuit recently noted: "Cause, not self. That is the sworn duty of the legal profession — to subordinate their own interests to those of their clients." *In re ABC Dentistry*, 978 F.3d 323 (5th Cir. 2020). The late Judge Henry Friendly put it even more succinctly: "The conduct of bankruptcy [cases] not only should be right but must seem right." *In re Ira Haupt & Co.*, 361 F.2d 164, 168 (2d Cir. 1966) (discouraging bankruptcy trustees from retaining their own law firm). *See also, In re Hayes*, 183 F.3d 162, 168 (2d Cir. 1999) ("… the attorney-client relationship entails one of the highest fiduciary duties imposed by law.").

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