

Expert Analysis

Navigating Counsel Conflicts Of Interest In Bankruptcy

By **Claire Wu**

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Disqualification of counsel disputes in bankruptcy matters can arise in many different contexts, ranging from disqualification of proposed debtor's counsel to disqualification of proposed litigation counsel in an adversary proceeding. Ordinarily, a disqualification motion in an adversary proceeding is brought by a party when counsel for one party owes a duty to another party, and has a conflict of interest arising from duties owed to both parties.

This can be a conflicting duty owed to a current client, a former client or even a nonclient. In regard to a lawyer or law firm's proposed representation of a debtor, this usually arises in the context of the professional's employment application.



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California Rules Governing Representation of Adverse Interests

Federal courts in California applying California law, including bankruptcy courts, do not have their own rules of professional conduct, but instead look to the California Rules of Professional Conduct.[1] California Rule of Professional Conduct 3-310 governs the representation of adverse interests. Failure to comply with this rule normally results in the disqualification of counsel.[2]

With respect to simultaneous representation, Rule 3-310 provides that an attorney is precluded from, "without the informed written consent of each client ... represent[ing] a client in a matter and at the same time in a separate matter accept[ing] as a client a person or entity whose interest in the first matter is adverse to the client in the first matter." [3]

As to successive representation, California Rule of Professional Conduct 3-310 provides that an attorney is precluded from, "without the informed written consent of the client or former client, accept[ing] employment adverse to the client or former client where, by reason of the representation of the client or former client, the member has obtained confidential information material to the employment." [4]

Partial Disqualification in a Conflict Involving Simultaneous Representation

Recently, in the bankruptcy case of Relativity Media LLC et al., [5] the Honorable Michael E. Wiles, United States Bankruptcy Judge for the Southern District of New York, issued a decision and entered an order on July 6 regarding the debtors' application for authority to retain Winston & Strawn LLP as their general bankruptcy counsel. The court's decision and accompanying order authorized the retention and employment of Winston & Strawn as debtors' counsel, but carved out from the firm's retention matters directly adverse to Netflix Inc., a client of the firm in a patent litigation matter in Delaware.

During the course of the Relativity bankruptcy case, Netflix had been outspoken in scrutinizing the debtors' conduct, and in particular, with regard to Netflix's prepetition contract with the debtors entitled "License Agreement for Internet Transmission." When the debtors sought to employ Winston & Strawn as their bankruptcy counsel, Netflix objected, arguing that Winston & Strawn's prepetition representation of Netflix in certain litigation matters pending in other courts precluded Winston & Strawn from being adverse to Netflix in the then-pending disputes in the Relativity bankruptcy case.

Specifically, in its objection, Netflix argued that Winston & Strawn's representation of the debtors in

disputes with Netflix would violate the California Rules of Professional Conduct, namely California Rule 3-310(C)(3), and breach Winston & Strawn's duties to Netflix under California law. Netflix acknowledged, however, that such ethical issues would need to be pursued in California, and not before the court in the Relativity bankruptcy case.

Notwithstanding the above, Netflix asked the bankruptcy court to take into consideration the question of whether Winston & Strawn's California conflicts should cause the court to decline to approve Winston & Strawn's retention insofar as it sought to be adverse to Netflix, or limit Winston & Strawn's retention to matters in the Relativity case other than any issues or disputes involving Netflix.

In response to the above and to a separate objection filed by the Office of the United States Trustee, debtors attempted to advance several arguments, including that (1) Netflix agreed in advance to waive conflicts, and (2) the firm, by the time of the July 3 hearing, had withdrawn from its representation of Netflix in the patent litigation matter in Delaware, which was what had led to the filing of the objection to their employment.

The bankruptcy court addressed and rejected both arguments in turn, stating that waivers of conflicts are only effective to the extent they are specific and are provided with informed consent, and that the "hot potato" rule makes clear that where a lawyer has sued a client in violation of the duties owed to that client, the lawyer cannot solve the problem by withdrawing from its previous conflicting representation of that client.

Ultimately, the bankruptcy court carved out from Winston & Strawn's retention matters involving (1) Netflix's adversary proceeding against the debtors; (2) the assumption and assignment of the debtors' executory contracts with Netflix; and (3) any additional matters that subsequently arise in the debtors' cases directly adverse to Netflix. The bankruptcy court further required, as a condition of Winston & Strawn's employment, that other counsel handle the debtors' disputes with Netflix.

Based on the above, the best practice for counsel, especially in circumstances where a potential conflict involving current clients is foreseeable, is to hire separate counsel or obtain the informed written consent of each client. Generic advance waiver language does not, under California law, constitute "informed" consent — the waiver should provide detailed information about the identity of the adverse party and the nature of the adversity, and disclose as fully as possible the nature of any potential conflict.[6]

Finally, counsel should be aware that an attempt to withdraw from representation of one client does not cure a breach of duty, as California's "hot potato" rule holds that is a further breach of fiduciary duty to drop a client in order to represent another client in a conflict situation.[7]

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[1] In re Muscle Improvement Inc., 437 B.R. 389, 393 (Bankr. C.D. Cal. 2010).

[2] Flatt v. Super. Ct., 9 Cal. 4th 275, 283, 36 Cal. Rptr. 537, 885 P.2d 950 (1994).

[3] Cal. Rules of Prof'l Conduct R. 3-310(C)(3).

[4] Cal. Rules of Prof'l Conduct R. 3-310(E).

[5] Relativity Media LLC et al. (Case No. 18-11358 MEW).

[6] See, e.g., *Western Sugar Coop. v. Archer-Daniels-Midland Co.*, 98 F. Supp. 3d 1074, 1083-84 (C.D. Cal. 2015); *Lennar Mare Island LLC v. Steadfast Ins. Co.*, 105 F. Supp. 3d 1100, 1115-19 (E.D. Cal. 2015).

[7] See *Flatt*, 885 P.2d at 957.