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## NEW DECISION BARS DEBTOR'S CHOICE OF COUNSEL DESPITE THE RETENTION OF CONFLICTS COUNSEL

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In a recent decision in the Chapter 11 case of *Project Orange Associates, LLC*, the court confronted an important issue that often arises in bankruptcy cases: whether the use of conflicts counsel is sufficient to permit court approval under section 327(a) of the Bankruptcy Code of a debtor's choice for general bankruptcy counsel that also represents an important creditor of the debtor in unrelated matters. Here, the conflict involved the debtor's largest unsecured creditor and an essential supplier. The office of the United States Trustee ("UST") objected to *Project Orange's* proposed retention of lead counsel based on the existence of the conflict and, further, argued that proposed counsel's conflict was inadequately disclosed in court documents. The court, in denying the retention, focused on the debtor's proposed counsel's conflict. The court noted that the proposed counsel acknowledged that resolving all past and future

**issues with the debtor's largest unsecured creditor (and a key supplier) was critical to the debtor's successful reorganization efforts. Because that creditor was essential to the viability of the debtor's business and plan confirmation, the court reasoned that the debtor's use of conflicts counsel to deal with issues relating to this creditor would not alleviate the lead counsel's requirement to be "disinterested" within the purview of section 101(14) of the Bankruptcy Code.**

In denying *Project Orange's* application to retain its general bankruptcy counsel, the court stressed the importance of the fact that the proposed counsel admitted the existence of a conflict based on its relationship with *Project Orange's* largest creditor. Later, although taking the position that there was no actual conflict because the creditor in question was and continues to be represented by the proposed counsel's foreign affiliate (and not the U.S. based counsel that *Project Orange* sought to retain), the proposed counsel did obtain a

conflict waiver letter and agreed not to bring or threaten litigation seeking money damages from or equitable relief against the creditor. The waiver letter permitted the proposed counsel to negotiate with the creditor and review documents and the debtor's contractual relationships with the creditor, so long as the debtor engaged conflicts counsel "with respect to the potential of bringing or prosecuting" any suit or contested matter against the creditor.

The court reviewed the law requiring that a debtor's professionals must be both disinterested and not hold or represent any interest adverse to the estate in order to be employed under Bankruptcy Code section 327(a). The court observed that a disinterested counsel must not hold any interest "materially adverse to the interest of the estate or of any class of creditors" for any reason. Further, the court observed that if a

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court determines that there is an actual conflict of interest following an objection from the UST or a creditor, the court must disapprove the employment.

The court found that given the acknowledged conflict with the debtor's largest and very important creditor, the proposed counsel's arguments that it should be allowed to represent the debtor in developing a plan of reorganization and work on other restructuring issues — and other matters not involving a direct litigation with the creditor — had no merit. Further, proposed counsel's arguments that the debtor's entry into a stipulation with the creditor resolved their mutual disputes (and thus the conflict) were likewise found unpersuasive as the stipulation did not resolve all of the issues or claims between the parties, but only provided for the resolution of the creditor's secured claim.

Although the court found that the issue of conflict is determined on a case by case basis, looking at the facts of each case, the court found the existence of an actual conflict in this case because (i) the creditor was critical to the process and the debtor's successful reorganization,

(ii) directly adverse interests continued to exist between the creditor and the debtor, and (iii) the potential for new and different litigation existed given the nature and importance of the ongoing relationship between the debtor and this creditor. In continuing its analysis, after concluding that a conflict existed, the court further determined that the conflict waiver letter failed to solve the conflict issue sufficiently enough to permit the retention. Moreover, the conflict waiver, by its terms, limited the proposed counsel's ability to act in the best interests of the debtor if those efforts would require bringing suit or threatening to bring suit against the creditor for monetary damages or seeking equitable relief. Therefore, even though the conflict waiver letter permitted negotiations on all issues, in reality, counsel would necessarily be hampered in any negotiations if it did not have the ability to threaten litigation if the discussions failed.

The court further determined that although it is possible in certain circumstances for conflicts counsel to solve the problem of proposed lead counsel's conflict arising from its representation of creditors in

unrelated matters, it would not solve the problem here. First, the requirement of disinterestness is mandatory. Second, conflicts counsel does not solve the problem where proposed counsel is conflicted from representing a debtor with regards to matters central to the bankruptcy case and the debtor's successful reorganization efforts.

Counsel should take notice of this latest reminder reinforced by the *Project Orange* decision that clearing conflicts is crucial to the debtor's ability to retain counsel of its choice. This may require the making of fulsome disclosures at the inception of the case, careful drafting of conflict waiver letters, and counsel's assurance that its representation of the debtor will be uninhibited by its relationships with other clients.

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<sup>1</sup> In re Project Orange Associates, LLC, — B.R. —, 2010 WL 2521073 (Bankr. S.D.N.Y. 2010).

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