"Yet Another View of *In re Pillowtex"*

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I was writing an article on conflicts of interest in bankruptcy cases when the December/January issue of the ABI Journal hit my desk. The issue contained not one, but two articles[2] discussing the implications of the Third Circuit's decision in *In re Pillowtex*, 304 F.3d 246 (2002). White and Medford's *Disinterestedness and Preferential Transfers* and Salerno and Kroop's *Revisiting Retentions* both offer sound guidance for the issues posed by *Pillowtex* for practitioners. I think, however, that *Pillowtex* reflects a far more significant caution than is reflected in these articles: the court in *Pillowtex* signals that practical fixes for conflicts of interest cannot ultimately cure practices specifically prohibited by the Bankruptcy Code. So, I think yet another article on *Pillowtex* is in order.

In *Pillowtex,* the Jones Day firm applied to be counsel for the debtor in possession. In its application it disclosed certain payments it had received pre-petition. The U.S. Trustee alleged that these payments were preferential and therefore disqualified the firm under the "adverse interest" and "disinterestedness" requirement of 11 U.S.C. § 327.[3] Jones Day claimed that the payments were not preferential. It further argued that, even if the payments were subsequently determined to be preferential, Jones Day could cure the problem by agreeing to return the payments in question.

The District Court for the District of Delaware, sitting as the bankruptcy court in Delaware, agreed with Jones Day and approved Jones Day's retention with conditions in its order that would require the firm to return any payments determined to be preferential. The U.S. Court of Appeals for the Third Circuit reversed, finding that "the court's order incorporating the two conditions does not resolve the question of whether Jones Day received an avoidable preference and was therefore not disinterested and whether it should have been disqualified."[4]

The articles of Messrs. White and Medford and Messrs. Salerno and Kroop reflect the general reaction to the *Pillowtex* decision. There is concern about the practical burdens that *Pillowtex* will impose on firms that represent debtors in possession;[5] speculation that the U.S. Trustee is getting into the preference recovery business, at least with regard to pre-petition payments to professionals;[6] the suggestion that everybody does

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[1] The views expressed in this article are those of the author and do not necessarily reflect the views of the Executive Office for U.S. Trustees or the Department of Justice.
[2] Bruce H. White and William L. Medford, *Disinterestedness and Preferential Transfers: Can't We Talk About This Later,* 21-JAN Am. Bankr. Inst.J. 38 (December 2002), Thomas J. Salerno and Jordan A. Kroop, *Revisiting Retentions for Professional Preferences,* 21-JAN Am. Bankr. Inst.J. 34 (December 2002).
[3] The *Pillowtex* court ultimately found that the payments, if preferential, would have rendered Jones Day disqualified under 11 U.S.C. § 327 (a) as holding an interest adverse to the estate, and under 11 U.S.C. § 327(c) as not being disinterested.
[4] *Pillowtex* at 253.
[5] Salerno and Kroop at 56.
[6] Id. at 56 ("Incredibly, the Third Circuit vindicated the U.S. Trustee's efforts by conferring standing to the U.S. Trustee to assert an avoidance action against Jones Day when only days earlier it had denied such standing to a creditors's committee in

it and creditors generally accept the practice;[7] and a discussion of the steps to take to avoid a *Pillowtex* issue.[8]

These concerns notwithstanding, *Pillowtex* sends a clear message that some conflicts will disqualify counsel, and disqualifying conflicts cannot be ignored.

Pillowtex builds upon a long line of Third Circuit cases that have disqualified counsel because of conflicts of interests. *Pillowtex* cites to *In re BH&P*[9] (bankruptcy court disqualifies counsel after "finding law firm had actual conflict of interest by representing both the trustee for the debtor in its chapter 7 proceeding and the two principals of the debtor"); *In re Marvel Entertainment*[10](court draws distinction between actual and potential conflicts of interest, and appearances of conflict of interest, and the consequences of each type of conflict for a professional seeking retention); and *In re First Jersey Securities*[11](court finds proposed counsel for debtor in possession disqualified where counsel received preferential payments).

As this line of cases shows, analysis of conflicts can require the drawing of fine distinctions among complex facts. *Pillowtex* reminds us that conflicts must be taken seriously: "Although a bankruptcy court enjoys considerable discretion in evaluating whether professionals suffer from conflicts, that discretion is not limitless."[12]

In this regard, *Pillowtex* is not just a case about how a law firm deals with a pre-petition receivable. The action by the U.S. Trustee in *Pillowtex* was not motivated by the prospect of recovery of a preference, but by the desire to assure that counsel met the standards required by Section 327. The case was pressed because an important line had been crossed, a line that had been drawn by the language of the statute and emphasized repeatedly by the Third Circuit, and that is intended to protect the integrity of the bankruptcy process.

At some level, it seems almost mundane to say that *Pillowtex* stands for the proposition that certain conflicts can disqualify a professional from being retained in a bankruptcy case. As White and Medford state, the notion is a matter of "black-letter law."[13] Yet, this very simple notion is under constant pressure as cases become more complex, law firms become larger, and different types of professionals become more widely used in these cases. Particularly at the early stage of a bankruptcy case, when there are so many other competing demands, everyone in the case faces pressures to allow a conflict to be addressed through disclosure, ethical walls, conflicts counsel, or some other device. *Pillowtex* should serve as an important reminder that some of these conflicts will be disqualifying regardless of the prophylactic steps that are taken. Whatever the inconvenience or practical problems presented, time and attention must be spent to assure that conflicts of interest are addressed fully and in a manner consistent with the Bankruptcy Code.

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[7] Id. at 56.

[8] White and Medford, at 54. ("Thus, professionals would be wise to resolve potential conflicts early in a bankruptcy case").

[9] *949 F.2d 1300 (3d Cir. 1991).*

[10] *140 F.3d 463 (3d Cir 1998).*

[11] *180 F.3d 504 (3d Cir. 1999).*

[12] *Pillowtex* at 254.

[13] White and Medford at 38.