

UNITED STATES BANKRUPTCY COURT  
EASTERN DISTRICT OF TENNESSEE  
SOUTHERN DIVISION

In re:

NORTH AMERICAN ROYALTIES, INC.

Debtor

No. 01-17271

Chapter 7

DOUGLAS R. JOHNSON, TRUSTEE

Plaintiff

v.

DRUMMOND Co., INC., dba ABC COKE

Defendant

Adversary Proceeding  
No. 03-1362

MEMORANDUM

Appearances: Douglas R. Johnson and Lex A. Coleman, Johnson, Mulroony & Coleman,  
P.C., Chattanooga, Tennessee, Attorneys for Plaintiff

Thomas E. Ray, Samples, Jennings, Ray & Gibbons, P.L.L.C.,  
Chattanooga, Tennessee, Attorneys for Defendant

HONORABLE R. THOMAS STINNETT  
UNITED STATES BANKRUPTCY JUDGE

The bankruptcy trustee brought this action to recover alleged preferential transfers to the defendant. 11 U.S.C. § 547. This memorandum deals with the trustee's motion for judicial inquiry and to disqualify the defendant's lawyer, Thomas E. Ray. The trustee asserts that Mr. Ray has a conflict of interest because he previously worked for the bankruptcy estate on the recovery of preferential transfers.

The ethical rules for lawyers practicing in this court are the same as the ethical rules for lawyers practicing in the state courts of Tennessee. E. D. Tenn. Loc. Bankr. Rule 2090-2. Those are the Rules of Professional Conduct adopted by the Tennessee Supreme Court. Tenn. S. Ct. R. 8. The parties in this proceeding are concerned with Rule 1.9(a). Tenn. S. Ct. R. 8, Rules Prof. Cond. 1.9(a). It provides:

A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client, unless the former client consents in writing after consultation.

The lawyer's prior representation of an opposing party may give him and his new client an unfair advantage. In particular, the lawyer may have obtained confidential information during his representation of the former client and may be able to use it against the former client. The rule is intended to prevent the misuse or abuse of the earlier attorney-client relationship. Rules Prof. Cond. 1.9, Commentary ¶ 3, ¶ 4, ¶ 6.

The lawyer's opportunity or lack of opportunity to acquire confidential information from the former client is relevant to two fundamental questions under Rule 1.9(a). Was the prior relationship an attorney-client relationship so that Rule 1.9(a) applies? Is there a substantial relationship between the prior legal matters and the current legal matter? See *Securities Investor Protection Corp. v. Blinder, Robinson & Co. (In re Blinder, Robinson & Co.)*, 123 B.R. 900 (Bankr. D. Colo. 1991) appeal dismissed sub nom. *Intercontinental Enterprises, Inc. v. Keller (In re Blinder,*

*Robinson & Co.*), 132 B.R. 759 (D. Colo. 1991); *Pereira v. Houze Glass Co. (In re Graff Marketing Corp.)*, 42 B.R. 801 (Bankr. S. D. N. Y. 1984); *Ramada Franchise System, Inc. v. Hotel of Gainesville Associates*, 988 F.Supp. 1460 (N. D. Ga. 1997); *Cardona v. General Motors Corp.*, 942 F.Supp. 968 (D. N. J. 1996).

Mr. Ray represented the unsecured creditors' committee in the bankruptcy case before it converted from Chapter 11 to Chapter 7. During that time, Mr. Ray did preferential transfer analyses as to numerous creditors and sent letters to about 43 creditors seeking to recover the alleged preferential payments. Apparently Mr. Ray did not do an analysis as to the defendant in this adversary proceeding.

The court must also point out that the debtor's local counsel (Kennedy, Koontz & Farinash) were involved with pursuing potential preferences before conversion of the case to Chapter 7, and they have continued to be involved since appointment of the trustee. Indeed, they filed the trustee's motion to strike part of the answer filed by Mr. Ray. Mr. Ray doubtlessly dealt with the lawyers while working on preference issues for the unsecured creditors' committee.

The bankruptcy trustee was appointed after conversion of the case to Chapter 7. According to Mr. Ray's brief, the trustee did not agree with his analysis of the ordinary course of business exception; the trustee takes the position that it protects fewer transfers. 11 U.S.C. § 547(c)(2). After the trustee's appointment, Mr. Ray began representing creditors from whom the trustee was attempting to recover alleged preferential transfers, including at least two creditors who received Mr. Ray's letter.

Mr. Ray contends that the bankruptcy estate is not a former client because he worked for the unsecured creditors' committee. For the purposes of Rule 1.9(a), a lawyer may have previously represented an opposing party even if the situation did not include all the formal or traditional indicators of an attorney-client relationship. *Ramada Franchise System, Inc. v. Hotel*

of *Gainesville Associates*, 988 F.Supp. 1460 (N. D. Ga. 1997); *Pereira v. Houze Glass Co. (In re Graff Marketing Corp.)*, 42 B.R. 801 (Bankr. S. D. N. Y. 1984). The court has already mentioned that one key indicator is whether the lawyer was in a position to obtain confidential information from the party.

The evidence leaves no doubt that Mr. Ray's work on preferential transfers was work for the bankruptcy estate. The interests of the bankruptcy estate and the unsecured creditors' committee were aligned to some extent when Mr. Ray worked on the recovery of preferential transfers, but it was the bankruptcy estate that had the power to recover preferential transfers. Mr. Ray can not make a valid distinction according to the change in identity of the bankruptcy estate's representative. While this case was pending under Chapter 11, the debtor in possession was the representative of the bankruptcy estate. When the case converted to Chapter 7, the Chapter 7 trustee became the representative of the bankruptcy estate. 11 U.S.C. §§ 103(a), 323(a) & 1107. In both situations, however, the bankruptcy estate was the party with the primary interest in recovering preferential transfers *and* the power to recover. Work done by Mr. Ray for the purpose of recovering preferential transfers was work done for the bankruptcy estate and amounts to representation of the bankruptcy estate. *Waldschmidt v. Compicare Health Services Ins. Corp. (In re Peck Foods)*, 196 B.R. 434 (Bankr. E. D. Wis. 1996); *Alper v. Meyer (In re Ram Manufacturing, Inc.)*, 49 B.R. 53 (Bankr. E. D. Pa. 1985).

Mr. Ray contends the situation did not involve the key indicator of an attorney-client relationship, access to confidential information. He focuses on the accounting data and the preference summaries that were produced from the data. The theory seems to be that the accounting data was not confidential in the bankruptcy case, and the preference summaries were released to the creditors involved.

Mr. Ray takes too narrow a view of the purpose of Rule 1.9(a). The rule protects the former client from the lawyer's *possible* use of confidential information *possibly* gained during

their earlier relationship to represent a new client in opposition to the former client. *Nathan v. Shea (In re Marks & Goergens, Inc.)*, 199 B.R. 922 (Bankr. E. D. Mich. 1996); *Waldschmidt v. Compicare Health Services Ins. Corp. (In re Peck Foods)*, 196 B.R. 434 (Bankr. E. D. Wis. 1996). The lawyer can be disqualified even if he did not obtain any confidential information or has not used any confidential information. Rule 1.9(a) does not make a distinction based on whether the information was confidential or has since been disclosed. The question is whether there is a substantial relationship between the old and the new legal matters.

Mr. Ray relies on a sixth circuit case for a stricter rule. *Dana Corp. v. Blue Cross & Blue Shield Mutual of Northern Ohio*, 900 F.2d 882 (6th Cir. 1990). The case was not decided under Rule 1.9(a). Rule 1.9(a) does not require proof that the lawyer actually obtained or is using confidential information. Furthermore, the *Dana* decision's statement of a stricter rule may not have accurately reflected the law in the sixth circuit at that time; the law may have been essentially the same as the current law under Rule 1.9(a). See *SST Castings, Inc. v. Amana Appliances, Inc.*, 250 F.Supp.2d 863 (S. D. Ohio 2002).

Mr. Ray's argument takes too narrow a view of Rule 1.9(a) in another respect. The rule is concerned with more than protecting a former client from the lawyer's use of confidential information against the former client. The rule is also concerned with loyalty to the client. When a lawyer switches sides in one proceeding, the problem is obvious. The same problem arises, however, when the lawyer represents a client and then represents an opposing party in a separate but substantially related matter. Tenn. S. Ct. R. 8; Rule Prof. Cond. 1.9(a), (b), (c); Ronald D. Rotunda, *The Lawyer's Deskbook on Professional Responsibility* § 10-1.2.3 (2002). The *Cardona* case from New Jersey presents a parallel situation. The lawyer had regularly represented an automobile manufacturer in lemon law cases. He then moved to a firm that represented plaintiffs in lemon law cases against the manufacturer. There was no overlap of particular cases against the manufacturer. The question was whether the new lemon law cases involving different plaintiffs

were substantially related to matters handled by the lawyer while he represented the manufacturer. One method of measuring the relationship was to consider whether the lawyer, during his earlier representation of manufacturer, had access to confidential information that might be useful in representing his new client against the manufacturer. The court was concerned that the lawyer had gained information while defending the manufacturer that was valuable in representing the plaintiff in its suit against the manufacturer. The court pointed out that each lemon law case was different in some way from all other lemon law cases. Each plaintiff was a different plaintiff. Nevertheless, all the lemon law cases were alike as to the legal issues they raised. The lawyer's prior representation of the manufacturer would have taught him how the manufacturer and its lawyers handled such cases. The problem, of course, was that a lawyer who learns from representing a client how it generally operates in a recurring type of litigation can not be forever barred from representing clients on the other side of the same type of litigation, even against the lawyer's former client. The court concluded that the lemon law case was substantially related to the earlier lemon law cases in which the lawyer represented the defendant manufacturer, and therefore, Rule 1.9 prohibited the lawyer and his firm from representing the plaintiff. *Cardona v. General Motors Corp.*, 942 F.Supp. 968 (D. N. J. 1996).

This proceeding raises essentially the same question, but the court has less difficulty in finding a substantial relationship because Mr. Ray took up the defense of various creditors against the trustee's preference claims shortly after he finished representing the bankruptcy estate. Furthermore, Mr. Ray apparently obtained information from the debtor or other sources while working for the bankruptcy estate that allowed him to oppose the trustee's preference claim more quickly and easily than he could have otherwise. The court will discuss this point in more detail when dealing with the alleged waiver by the trustee of any conflict under Rule 1.9(a).

Other cases also make the point that matters may be substantially related when neither the parties nor the issues are exactly the same. *Waldschmidt v. Compcare Health Services Ins. Corp. (In re Peck Foods)*, 196 B.R. 434 (Bankr. E. D. Wis. 1996); *Pereira v. Houze Glass Co. (In re Graff Marketing Corp.)*, 42 B.R. 801 (Bankr. S. D. N. Y. 1984).

The court concludes that Mr. Ray is representing a client whose interests are materially adverse to a former client, the bankruptcy estate, and this matter is substantially related to the matters in which he previously represented the bankruptcy estate. Furthermore, the bankruptcy estate has not consented in writing to Mr. Ray's representation. Mr. Ray contends that the bankruptcy trustee has impliedly consented or is estopped to raise the disqualification question.

Implied consent, waiver, or estoppel can prevent disqualification under Rule 1.9(a). *Official Unsecured Creditors Committee v. Ampco-Pittsburgh Corp. (In re Valley-Vulcan Mold Corp.)*, 237 B.R. 322 (6th Cir. B.A.P. 1999), *aff'd* 5 Fed.Appx. 396, 2001 WL 224066 (6th Cir. 2001); *In re Muma Services, Inc.*, 286 B.R. 583 (Bankr. D. Del. 2002). For convenience, the court will refer to the issue as waiver even though it may not be the most accurate term for all situations.

The briefs from Mr. Ray and the trustee leave no doubt that they discussed the possible conflict, and the trustee consented to Mr. Ray's representation of a creditor in one case in August 2003. Indeed, the conflict was so obvious that the trustee and Mr. Ray surely would have discussed it. Mr. Ray and the trustee disagree as to whether the trustee intended to waive the conflict for all the trustee's preference suits. The trustee denies that he ever indicated his consent for all preference suits. Mr. Ray's brief goes on to say that he does not intend to rely on consent for all preference cases. Mr. Ray does not seek a decision by the court as to whose memory is correct.

The trustee's reply brief asks for an evidentiary hearing. Apparently, he wants the court to hear testimony as to his discussions with Mr. Ray regarding waiver. The court sees no need for it. Mr. Ray is not relying on an express oral waiver by the trustee for all preference claims. The court's decision, which follows, does not depend on what the trustee intended or what Mr. Ray believed regarding an express waiver for all preference claims.

As to waiver, Mr. Ray relies primarily on events concerning *other* creditors that he defended against earlier preference claims by the trustee. The trustee did not file suit against all the creditors that Mr. Ray represented, but he still represented them against the trustee's preference claims. Mr. Ray states that the trustee knew he was representing creditors no later than August 2003 when he appeared on behalf of another creditor. Mr. Ray cites other, later instances in which he represented other creditors from whom the trustee sought to recover preferences, and the trustee knew he represented them. The trustee has not denied these statements by Mr. Ray.

Mr. Ray's argument raises the question of whether the trustee's failure to object in earlier, separate preference proceedings can result in waiver in this proceeding. The trustee's failure to object in earlier proceedings necessarily reduced Mr. Ray's expectation of an objection in later proceedings. If Mr. Ray had been involved with only one preference claim before this lawsuit, then he might not have been justified in thinking the trustee had waived the conflict for all preference claims, but Mr. Ray had represented more than one defendant without any objection by the trustee. The trustee does not claim that he informed Mr. Ray of the standards he would apply for deciding when to object to Mr. Ray's representation of a defendant. Mr. Ray was justified in thinking that (1) any objection in future proceedings was unexpected, and (2) if the trustee decided to object, the objection would come early in the proceeding since the trustee was aware of the problem. The result is that the trustee's failure to object in earlier proceedings shortened the time for a timely objection in later proceedings, such as this one.

The failure to object in the earlier proceedings also made the situation ripe for the use of an objection as a litigation tactic. An objection (a motion to disqualify) is a litigation tactic when the moving party is attempting to replace the opposing lawyer for some reason unrelated to the policies behind Rule 1.9(a). Any number of inappropriate criteria could be used to decide when to object. Is the preference claim a large amount? Do the facts favor defenses that the opposing lawyer has raised in the past? Has the opposing lawyer's litigation strategy become aggravating? An objection for any of these reasons would be a litigation tactic and not an attempt to enforce Rule 1.9(a). If it appears that an objection under Rule 1.9(a) is a litigation tactic, then the objection may be too late even though only a short time has elapsed since filing of the complaint. *Official Unsecured Creditors Committee v. Ampco-Pittsburgh Corp. (In re Valley-Vulcan Mold Corp.)*, 237 B.R. 322 (6th Cir. B.A.P. 1999) (factors), *aff'd* 5 Fed.Appx. 396, 2001 WL 224066 (6th Cir. 2001)

The facts in this proceeding suggest that the trustee may be unhappy with Mr. Ray's tactics. Problems began when the answer filed by Mr. Ray included the defense that the complaint fails to state a claim upon which relief can be granted. Including this defense in an answer has been common practice in the past. It preserves the defense without making a motion to dismiss before filing the answer. Fed. R. Bankr. P. 7012; Fed. R. Civ. P. 12(b). The defendant did not file a motion or otherwise assert the defense, and the court did not require briefs or otherwise indicate that it would rule on the defense based solely on the complaint and answer. The trustee, however, filed a motion to strike the defense on the ground that the complaint obviously stated a claim.

The trustee's motion to strike also applied to the defense that process or service of process was insufficient. The trustee asked that this defense be struck from the answer because it did not allege any facts to show the alleged insufficiency. In any event, the trustee's

motion to strike resulted in an order from the court intended to force the parties to try the issues raised by the two defenses.

The motion to strike was filed a month and a day after the complaint was filed. A week later – about five weeks after the complaint was filed – Mr. Ray filed a motion for partial summary judgment. The motion is based on the ordinary course of business exception. 11 U.S.C. § 547(c)(2). To decide whether the ordinary course exception applies, the court generally must take a close look at a broad range of facts, and the facts are often in dispute. This is not to say that summary judgment is unlikely as to the ordinary course exception. A motion for summary judgment may be used to settle the law the court will apply with regard to some undisputed facts. Arguably, this was the point of the defendant's motion for partial summary judgment. Still, the motion was filed early in this adversary proceeding, *and* that may have been easier for Mr. Ray as the result of his earlier work for the bankruptcy estate on the recovery of preferential transfers. His earlier work for the bankruptcy estate should have made him familiar with general facts regarding the debtor's dealings with its creditors and with practices in the industry. According to the trustee, Mr. Ray had access to all the debtor's employees who knew the relevant facts, especially the facts relevant to the ordinary course of business exception. 11 U.S.C. § 547(c)(2). Mr. Ray may also have learned the trustee's theories as to the legal effect of particular fact patterns for purposes of the ordinary course of business exception. Of course, Mr. Ray did not learn these legal theories from the trustee or his law firm since the trustee had not been appointed. But he may have learned them from lawyers representing the bankruptcy estate. In summary, Mr. Ray's prior work for the bankruptcy estate probably allowed him to make the motion very early in this adversary proceeding.

Mr. Ray filed a response to the trustee's motion to strike the two defenses about a week later, a total of six weeks after the complaint was filed.

About two weeks later Mr. Ray filed an objection to the trustee's motion to extend the time to respond to the summary judgment motion. This was two months after the complaint was filed and three weeks after the defendant filed the motion for partial summary judgment. The objection was actually filed the day before the trustee filed the motion for an extension. The objection applied to the length of the requested extension. The defendant did not object to an additional thirty days, but the trustee's motion asked for sixty.

The objection in effect criticized the trustee for not being prepared on the facts regarding the ordinary course exception. Again, these were facts that Mr. Ray had the opportunity to become familiar with when he was working on preference recoveries for the bankruptcy estate – before the trustee was appointed. The motion for partial summary judgment relied on affidavits from two officers of the debtor (or one of its divisions), Lorie Mallchok and Randy Lee Williams. The trustee and his lawyers may have already been familiar with the facts stated by these witnesses and may not have needed much time to make a response. But the motion for partial summary judgment also relied on affidavits from two other witnesses with regard to the ordinary course of business and ordinary business terms. 11 U.S.C. § 547(c)(2). One witness was the defendant's credit manager. The other was presented as an expert on industry standards. 11 U.S.C. § 547(c)(2)(C). The trustee may have needed more time to prepare a response to these affidavits, especially since the trustee was pursuing about 180 adversary proceedings in this bankruptcy and its related cases.

The events suggest that Mr. Ray has an advantage over other lawyers representing preference defendants because his earlier work on preference recoveries for the bankruptcy estate made him familiar with the facts and the trustee's view of the law. Nevertheless, the evidence does support the conclusion that the trustee's motion is merely a litigation tactic. Indeed, the court has not seen any behavior by any of the lawyers to indicate that it is. The question, then, is whether the trustee's delay in filing the motion to disqualify makes it unfair to disqualify Mr. Ray.

First, the court needs to deal with a preliminary point. At the beginning of this adversary proceeding, Mr. Ray could have asked the trustee for written consent to his representation of the defendant. If the trustee had refused, however, that would not necessarily have alerted Mr. Ray to expect a motion to disqualify, in light of the trustee's failure to object in earlier proceedings. Furthermore, waiver might never apply if a request for written consent is a prerequisite. Mr. Ray's failure to ask for written consent does not prevent waiver by the trustee.

The trustee filed the motion to disqualify almost exactly three months after the complaint was filed. That was about a month after all the pleadings mentioned above – the defendant's answer, the trustee's motion to strike parts of the answer, the court's order regarding the motion to strike, the defendant's motion for partial summary judgment, the defendant's response to the motion to strike, the trustee's motion to extend the time to respond to the motion for partial summary judgment, and the defendant's objection to the extension of time. Most cases of waiver involve longer delays. *Official Unsecured Creditors Committee v. Ampco-Pittsburgh Corp. (In re Valley-Vulcan Mold Corp.)*, 237 B.R. 322 (6th Cir. B.A.P. 1999), *aff'd* 5 Fed.Appx. 396, 2001 WL 224066 (6th Cir. 2001); *In re Muma Services, Inc.*, 286 B.R. 583 (Bankr. D. Del. 2002); *In re Kids Creek Partners, L.P.*, 220 B.R. 963 (Bankr. N. D. Ill. 1998); *In re Spivey Chevrolet, Inc.*, 204 B.R. 32 (Bankr. E. D. Ark. 1996). Not all the cases involve long delays. The delay in the *Enron* case was only a few months, but the court still found a waiver. *In re Enron Corp.*, 2002 WL 32034346, No. 01-16034 (Bankr. S. D. N. Y. May 23, 2002).

The trustee's response to Mr. Ray's brief states that the trustee did not file the motion until February because other matters in this adversary proceeding had a higher priority, and he was busy with other higher priority matters in the bankruptcy case. The trustee also argues that Mr. Ray and his clients could not have been surprised by the motion since they knew the trustee's position that there was a conflict and did not have his written consent (waiver). The latter argument seems to favor Mr. Ray and his clients instead of the trustee. The trustee took the

position there was a conflict, and Mr. Ray and his clients knew it, but there was no quick motion by the trustee to disqualify Mr. Ray, and the trustee had consented in earlier proceedings. These facts support an implied waiver.

As to other legal matters having a higher priority, this may have been a good reason for the trustee's delay from his point of view. A good reason for the trustee's delay, however, does not mean the delay will not be held against the trustee. This is true even if Mr. Ray knew of the reason. He and his client still had good reasons to expect an early motion or no motion at all.

In *Valley-Vulcan* the court mentioned other factors that should be considered – when the moving party learned of the conflict, whether the moving party was represented by counsel during the delay, other reasons for the delay, whether the motion is a litigation tactic, which may be indicated by delay, and prejudice to the non-moving party if its lawyer is disqualified. *Official Unsecured Creditors Committee v. Ampco-Pittsburgh Corp. (In re Valley-Vulcan Mold Corp.)*, 237 B.R. 322, 337 (6th Cir. B.A.P. 1999), *aff'd* 5 Fed.Appx. 396, 2001 WL 224066 (6th Cir. 2001) The trustee knew of the conflict and was represented by counsel from the beginning of this adversary proceeding. The trustee did not make the motion to disqualify, however, until Mr. Ray had done a substantial amount of work in his representation of the defendant. Of course, the defendant will be prejudiced if Mr. Ray is disqualified, and another lawyer must step in and play catch-up.

In this situation, the relatively short delay by the trustee was enough for waiver of the objection. The court concludes that the trustee's motion to disqualify was filed too late and will be overruled.

This Memorandum constitutes findings of fact and conclusions of law as required by *Fed. R. Bankr. P. 7052*.

ENTER:

BY THE COURT

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Honorable R. Thomas Stinnett  
United States Bankruptcy Judge

Entered 5/5/04