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Conflicts Force Big Law Firms to Lose Clients; Lawsuits Abound From the Financial Crisis, but Ethics Rules Are Tying Hands; Smaller Outfits Get the Business

By NATHAN KOPPEL

Big blue-chip law firms are losing potentially lucrative assignments to smaller firms even as the industry sees a spike in lawsuits against banks stemming from the financial crisis.

The reason for the change: ethics rules that govern conflicts of interest for lawyers and their firms.

Law firms usually can't sue or investigate banks that they have represented, unless the clients take the unusual step of waiving the conflict. Thus, many small to midsize firms, which count fewer banks as defense clients, are filling a growing demand for conflict-free lawyers able to file lawsuits against banks.

Litigation against banks includes claims that they misstated the value of mortgage-related securities or reneged on financing agreements. Ambac Assurance Corp. recently sued a unit of Credit Suisse Group, alleging the securities firm made misleading representations about attributes of home-equity lines of credit backing bonds the insurer guaranteed. A Credit Suisse spokesman says the suit lacks merit. Last year, MBIA Insurance Corp. sued Countrywide Financial Corp., now owned by Bank of America Corp, claiming it misrepresented the quality of mortgage-backed securities. Bank of America declined to comment.

Consolidation in the banking business has made it only harder for law firms to handle lawsuits against banks. It is increasingly difficult, lawyers said, for firms to find a major bank they haven't represented at some point. As a result, they are bumping up against the conflict-of-interest rules formulated by the American Bar Association and state bar groups.

The development is particularly frustrating to leaders at the nation's law firms, which, over the past two years, have sustained a decline in business steeper than any in the past 20 years. At many, revenue and profit have dipped, and firms have turned to cost cutting, mostly by laying off lawyers and staff by the dozens.

A survey by Citi Private Bank's Law Firm Group of 50 of the country's 100 largest firms, as measured by revenue, found last year's revenue at the firms was down an average 4% from 2008. These same firms, according to Citi, averaged 7% revenue growth in 2008, and 12% growth from 2001 to 2007. At the same time, smaller law firms have been helped by the fact that they often charge less than large firms—an advantage at a time when companies have had to cut their legal budgets.

Houston bankruptcy lawyer Hugh Ray said he grew so irritated by conflicts last year that he left Andrews Kurth LLP, a 400-lawyer firm he had called home for four decades. The firm counts many financial firms as clients.

Mr. Ray moved to McKool Smith, a 125-lawyer Texas firm with no bank clients. "I came over because my phone was ringing with big-case opportunities, but it kept raising conflicts," the 67-year-old attorney said.

One challenge, he said, came up in the bankruptcy of Tulsa, Okla., oil company SemGroup LP. Mr. Ray said his clients in the bankruptcy matter, a group of oil producers, had been sued by an affiliate of Goldman Sachs Group Inc.

Andrews Kurth told Mr. Ray to step aside in the suit because it had represented Goldman Sachs. Mr. Ray now is handling the suit at his new firm. He said that Andrews Kurth wasn't technically prevented by a conflict from handling the litigation, but it still declined to do so because it didn't want to risk alienating a bank it had represented. Andrews Kurth didn't return requests for comment. Goldman Sachs declined to comment.

The freedom to sue financial firms "is one the single biggest ingredients to the success of our firm," said Michael Carlinsky, a partner at Quinn Emanuel Urquhart & Sullivan LLP. At 400 lawyers, it is as big as some leading corporate-law firms, but Quinn Emanuel has purposely tried to avoid building a banking clientele so that it would have a freer hand to litigate against banks.

Last year, Quinn Emanuel was tapped to represent Washington Mutual Inc. in a suit against J.P. Morgan Chase & Co. The dispute centers around who owns about $4 billion in assets that J.P. Morgan claims it acquired in its 2008 takeover of Washington Mutual's banking operations.

New York law firm Weil, Gotshal & Manges LLP, with 1,200 lawyers, is representing Washington Mutual in its ongoing bankruptcy, but Weil was conflicted from squaring off against J.P. Morgan, according to Quinn Emanuel's Mr. Carlinsky. Quinn Emanuel has had 10 lawyers working on the litigation, Mr. Carlinsky said.

Smaller firms also are gaining increasing market share in white-collar criminal matters. These firms, lawyers said, often have a freer hand to represent Wall Street executives, who regularly assert defenses that cast their employers in a negative light. At the same time, many of the small to midsize firms can offer top-flight counsel.

"Increasingly, in criminal cases you'll see individuals represented by boutique law firms," said Steven Molo, a partner at a six-lawyer New York firm, MoloLamken LLP. Earlier this year, for example, Mr. Molo represented Eric Butler, a former Credit Suisse Group broker sentenced for misleading investors.

Mr. Molo said he wouldn't have been able to handle the matter last year, when he was a partner at 900-lawyer Shearman & Sterling LLP, a large international firm that counts Credit Suisse as a client.

"Conflicts was a factor in my leaving Shearman," he said.

The big law firms are trying to buck the trend. Ethics specialists say the large firms increasingly are seeking waivers or are presenting arguments about why a seeming conflict shouldn't technically disqualify a firm from handling a certain matter. Excuse-making is on the rise," said Lawrence Fox, a partner at Drinker, Biddle & Reath LLP in Philadelphia who teaches class on ethics at Harvard Law School.

Conflicts, to be sure, are far from a mortal threat to blue-chip firms. Banks and other corporate clients occasionally will sign waivers, allowing firms to take on legal work even if it might impinge on the clients' legal rights.

Still, as law firms continue to expand internationally, taking on more matters for a growing list of clients, conflicts only will grow harder to avoid.

"Any time a firm is growing and taking on more clients that is good news, but it means more conflicts," said Terry Conner, the managing partner of 550-lawyer Haynes & Boone LLP, a Dallas-based firm that represents many regional and international banks. "We spend a lot of time managing conflicts; it's a fairly constant process," he said.