AMERICAN BANKRUPTCY INSTITUTE

2020 Central States Virtual Bankruptcy Workshop

Great Debates

Jay Alix v. McKinsey

Resolved: A financial advisor is required to disclose all connections, including the connections of its affiliates, when filing an application to be employed with the court.

Brian A. Audette
Perkins Coie LLP; Chicago

Claire Ann Richman
Steinhilber Swanson LLP; Madison, Wis.

The Ethical Response to Client Misconduct

Resolved: If a client either refuses to comply with an obligation imposed by the Bankruptcy Code or Rules, or insists on taking action prohibited by the Code or Rules, the client's attorney must file a motion to withdraw from representing the client and must disclose the disagreement regarding the client's legal obligations.

Michael P. Richman
Steinhilber Swanson LLP; Madison, Wis.

Hon. Eugene Wedoff (ret.)
Chicago

Conflict Disclosures of Affiliates

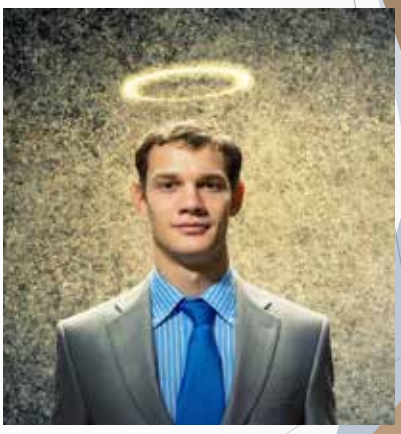
ABI Central States Debate

June 17, 2020

Claire Ann Richman, Steinhilber Swanson LLP

Issue

- A financial advisoris required to disclose all connections, *including the connections of its affiliates*, when filing an application to be employed with the Court?
- My position: YES



Bankruptcy Code

- 11 U.S.C. § 327(a) – employed professional must be a "disinterested person"
- 11 U.S.C. § 101(14) – defines "disinterested person"
  - (a) Is not a creditor, an equity security holder, or an insider
  - (b) Is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and
  - (c) Does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity securityholders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.
- 11 U.S.C. § 1103(b) – a committee professional may not also represent an entity holding an adverse interest

Rule 2014

- Requires a verified statement by the person to be employed disclosing the connections that person has with parties in interest and attorneys and accountants in the case
- This requirement is *strictly construed*

Illegal Fee Sharing

- 11 U.S.C. § 504 - prohibits any person receiving compensation under §§ 503(b)(2) or (b)(4) from sharing such compensation with another person (with some exceptions)

In re Trust America Service Corp., 175 B.R. 413 (Bankr. M.D. Fla. 1994)

- An accounting firm's conflict search must encompass *all departments and locations*, not only those doing work on the case

In re United Cos. Fin. Corp., 241 B.R. 521 (Bankr. D. Del. 1999)

- Affiliates that will perform services for the Debtor must disclose their connections
- *See also In re ACandS, Inc.*, 297 B.R. 395, 404 (Bankr. D. Del. 2003)

Policy Considerations

- Do we really want to allow any professional to carve itself up into an affiliate for each partner and employee, and then only disclose the connections of the specific people working on the case, even if a partner has a disqualifying conflict of interest?


Steinhilber
Swanson LLP
Attorneys at Law
Tell the truth, the whole truth.

The Central States Virtual Bankruptcy Workshop

Great Debate II—

Resolved: If a client either refuses to comply with an obligation imposed by the Bankruptcy Code or Rules or insists on taking action prohibited by the Code or Rules, the client's attorney must file a motion to withdraw from representing the client and must disclose the disagreement regarding the client's legal obligations.

Pro: Gene Wedoff Con: Michael Richman

Great Debate II—The basic question

It's pretty clear that an attorney can't properly aid a client in violating the Code and Rules, so withdrawing if the client insists on a violation is necessary.

The basic question is whether, as the debate resolution states, the attorney should have to disclose the past or threatened misconduct when moving to withdraw.

Great Debate II—your materials:

1. C.R. "Chip" Bowles, Jr. and Prof. Nancy Rapoport, "Debtor Counsel's Fiduciary Duty: Is There a Duty to Rat in Chapter 11?" 29 Am. Bankr. Inst. J. 16 (February 2010).

2. Michael P. Richman and Anthony Nguyen, "A Response: Is It Really a Chapter 11 Debtor Counsel's Duty to Rat? " 29 Am. Bankr. Inst. J. 18 (April 2010).

Great Debate II—other relevant material:

1. C.R. "Chip" Bowles, Jr., "Noisy Withdrawals: Urban Legend or Invaluable Ethical Tool?," 20 Am. Bankr. Inst. J. 26 (October 2001).

2. Alec P. Ostrow, "We Don't Need the Case Law to Turn the DIP's Attorney into a Court Informant," 27 Am. Bankr. Inst. J. 14 (May 2008).

Great Debate II—Pro:

C.R. "Chip" Bowles, Jr.

A staple at ABI conferences, Chip was best known for his cast of characters, such as "Amadous Myfasto" and "Boris Badenoff."

Great Debate II—ABA Model Rules and Comments:

1. Rule 1.6: Confidentiality of Information

   (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

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Great Debate II—ABA Model Rules and Comments:

1. Rule 1.6: Confidentiality of Information

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

. . . (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

Great Debate II—ABA Model Rules and Comments

1. Rule 1.6: Confidentiality of Information

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

. . . (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services

Great Debate II—ABA Model Rules and Comments

2. Rule 3.3: Candor Toward the Tribunal

(a) A lawyer shall not knowingly:

(1) make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer;

Great Debate II—ABA Model Rules and Comments

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(a) A lawyer shall not knowingly:

(3) offer evidence that the lawyer knows to be false. If a lawyer, the lawyer's client, or a witness called by the lawyer, has offered material evidence and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal. A lawyer may refuse to offer evidence . . . that the lawyer reasonably believes is false.

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Great Debate II—ABA Model Rules and Comments

2. Rule 3.3: Candor Toward the Tribunal

Comment [10]: [After learning of false material evidence submitted by a client] the advocate's proper course is to remonstrate with the client confidentially, advise the client of the lawyer's duty of candor to the tribunal and seek the client's cooperation with respect to the withdrawal or correction of the false statements or evidence.

Great Debate II—ABA Model Rules and Comments

2. Rule 3.3: Candor Toward the Tribunal

Comment [10]: If withdrawal from the representation is not permitted or will not undo the effect of the false evidence, the advocate must make such disclosure to the tribunal as is reasonably necessary to remedy the situation, even if doing so requires the lawyer to reveal information that otherwise would be protected by Rule 1.6.

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Great Debate II—ABA Model Rules and Comments

2. Rule 3.3: Candor Toward the Tribunal

Comment [11]: [The alternative to disclosure of a client's false testimony] is that the lawyer cooperate[s] in deceiving the court, thereby subverting the truth-finding process which the adversary system is designed to implement. . . . Furthermore, unless it is clearly understood that the lawyer will act upon the duty to disclose the existence of false evidence, the client can simply reject the lawyer's advice to reveal the false evidence and insist that the lawyer keep silent.

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Great Debate II—ABA Model Rules and Comments

3. Rule 1.16: Declining or Terminating Representation

(a) Except as stated in paragraph (c), a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if:

(1) the representation will result in violation of the rules of professional conduct or other law;

Great Debate II—ABA Model Rules and Comments

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Great Debate II—ABA Model Rules and Comments

3. Rule 1.16: Declining or Terminating Representation

(c) A lawyer must comply with applicable law requiring notice to or permission of a tribunal when terminating a representation. When ordered to do so by a tribunal, a lawyer shall continue representation notwithstanding good cause for terminating the representation.

Great Debate II—ABA Model Rules and Comments

3. Rule 1.16: Declining or Terminating Representation

Comment [3]. Difficulty may be encountered if withdrawal is based on the client's demand that the lawyer engage in unprofessional conduct. The court may request an explanation for the withdrawal . . . . The lawyer's statement that professional considerations require termination of the representation ordinarily should be accepted as sufficient. Lawyers should be mindful of their obligations to both clients and the court under Rules 1.6 and 3.3.

Great Debate II—ABA Model Rules and Comments

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Great Debate II—Relevant situations from Chip

- Refusal to pursue claims against insiders. *See, e.g., In re DeVlieg Inc.*, 174 B.R. 497 (N.D. Ill. 1994).
- Failure to properly market or sell estate assets. *See, e.g., In re Wilde Horse Enterprises Inc.*, 136 B.R. 830, 838 (Bankr. C.D. Cal. 1991).
- Violation of court orders by insiders. *See, e.g., In re Food Management Group, LLC.*, 380 B.R. 677 (Bankr. S.D.N.Y. 2008) (collusive bidding).
- Conversion, concealment or misuse of estate property. *See, e.g., In re Ward*, 894 F.2d 771, 776 (5th Cir. 1990).

Great Debate II—Best answer to the proposition

- Michael has suggested that simple withdrawal is enough: "[W]ithdrawal may provide a signal to the court or U.S. Trustee that something is amiss, and that further investigation is necessary—all while still preserving attorney-client confidentiality."
- But simple withdrawal might not trigger further investigation, other parties may be seriously harmed by the client's misconduct, and there might be no deterrence of bad conduct by other clients.
- Disclosure of the problem is the best approach.

Debtor Counsel's Fiduciary Duty: Is There a Duty to Rat in Chapter 11?

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This installment of Straight & Narrow takes a different form, as it is a counterpart to **Alec Ostrow**'s excellent 2008 article[1] in the *ABI Law Review* concerning the extent of the duties of a chapter 11 debtor's counsel (DIP counsel) to a chapter 11 bankruptcy estate and its management.[2]

If a Lawyer Has the Estate for a Client, Does the Client Have a Fool for a Lawyer?

C.R. "Chip" Bowles, Jr.

Bankruptcy is not like the rest of the legal world, in which the name of the client can give the lawyer a real understanding about whom she represents. It's too facile to say that DIP counsel only represents the DIP and, therefore, she only owes a fiduciary duty to the DIP—because the DIP itself is a fiduciary for the bankruptcy estate. It's also precious little guidance to say (although we have) that DIP counsel is estate counsel, unless we also spell out what that means.

What does it mean to represent the estate? It is literally true that DIP counsel does not represent all of the various constituencies with an interest in the outcome of the case. For example, DIP counsel must have a separate role from that of counsel for the creditors' committee, because those two entities can often have interests that conflict. Creditors' committee counsel represents the unsecured creditors as a group and must take those interests into account when advising the creditors' committee. The same principle holds true for other constituencies interested in distributions from the estate, and thankfully it is not true that DIP counsel owes a duty to individual creditors (or, for that matter, individual equity securityholders).[3]

Although the constituents with a claim on estate assets—secured creditors, unsecured creditors and owners when there are sufficient assets left over—have representation already, it is not quite true to say that DIP counsel can take its marching orders from the DIP without consideration of the fiduciary needs *of the estate itself*. There is a theory missing here, and that is why there has been some real discomfort in trying to spell out exactly what DIP counsel's responsibilities are. No normal theories really fit, which is why questions like whether DIP counsel has a duty to rat on a misbehaving DIP are so confounding.

Part of the reason that DIP counsel owes something to the estate is that the estate's funds (read: money coming from the pockets of the unsecured creditors) are paying her fees and expenses. Do not get us wrong: There is an ethics rule in place that clearly states that the person who pays the bill, if that person is not the client, does not get to call the shots in the case.[4] Here, though, the estate is the *raison d'etre* of the reorganization: maximizing it, restructuring it and coming out successfully on the other side of chapter 11. The DIP is charged with the rights, powers and duties of a trustee in chapter 11 under 11 U.S.C. §1107. Of course, that statement just puts us back right where we started, in an infinite loop: The DIP itself is a fiduciary for the estate as a whole.

Prof. Nancy B. Rapoport

In a sense, being counsel for the DIP is a lot like being counsel for a corporation: Counsel takes its marching orders from management (the bankruptcy analogy would be the DIP) but is beholden to the ultimate owners (for a corporation, the shareholders; for the DIP, the "owners" to whom the DIP owes allegiance is the estate—those "owning" the estate during the case and the owners eventually emerging on the other side of a successful reorganization).[5] In "normal" (nonbankruptcy) cases, the ethics rules recognize the tensions inherent in representing an entity, providing an understanding of the difference between direction (marching orders) and role (allegiance to shareholders) in the rule that provides for "up the chain" reporting when representing an organization as the client.[6] Being counsel for the DIP is different from being counsel for the corporation though because DIP counsel's behavior as an officer of the court is a significant component of the representation as well.

Straight & Narrow

1 Ostrow, "We Don't Need the Case Law to Turn the DIP's Attorney into a Court Informant," 27 *ABI L. J.* 14 (May 2008).

2 For purposes of this article, "management" will also include an individual chapter 11 debtor who is acting as a debtor-in-possession in his or her chapter 11 case. For a discussion of the particular problems of DIP counsel's duties concerning an individual chapter 11 debtor, *see* Bowles, Schaaf and Stosberg, "Ghosts of Individual Chapter 11 Debtors (Parts I and II)," 25 *ABI L. J.* 46 (December/January 2007) & 26 *ABI L. J.* 36 (February 2007).

3 *See ICM Notes Ltd. V. Andrews & Kurth LLP*, 278 B.R. 117 (S.D. Tex. 2002), *aff'd, In re ICM Notes Ltd.*, 324 F.3d 768 (5th Cir. 2003) (holding that DIP counsel does not hold fiduciary duty to specific creditors).

4 MRPC 1.8(f), www.abanet.org/cpr/mrpc/rule_1_8.html.

5 This concept is what the Supreme Court was getting at in *Commodity Futures Trading Comm'n v. Weintraub*:

> In light of the lack of direct guidance from the Code, we turn to consider the roles played by the various actors of a corporation in bankruptcy to determine which is most analogous to the role played by the management of a solvent corporation. Because the attorney-client privilege is controlled, outside of bankruptcy, by a corporation's management, *the actor whose duties most closely resemble those of management* should control the privilege in bankruptcy, unless such a result interferes with policies underlying the bankruptcy laws.

Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 352 (1985) (citation omitted; emphasis added).

6 *See* Model Rule of Professional Conduct 1.13 (organization as client), www.abanet.org/cpr/mrpc/rule_1_13.html.

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Straight & Narrow: Debtor Counsel's Fiduciary Duty

from page 16

In part because the chapter 11 process is incredibly complex and because parties' allegiances can shift constantly during the pendency of the chapter 11 case,[7] DIP counsel is under a duty to keep the court updated as to its disinterestedness.[8] Courts care about disclosure and about playing by the rules. Because the DIP itself generally is run by people who decidedly are not disinterested,[9] it is the disinterested DIP counsel who must look beyond the wishes of the DIP's management team to the overall needs of the estate and its ultimate residual owners.

Sure, all lawyers are officers of the court in the larger sense of the concept. We are not supposed to lie to courts,[10] let our clients lie to courts[11] or engage in conduct "prejudicial to the administration of justice," even when we're not representing a client.[12] Our conduct is proscribed in all sorts of ways to keep the system looking (and acting) fair.

We think that there is more required of those lawyers who are being paid from estate funds. In all such cases it is the unsecured creditors who are ponying up the funds out of their own pockets for the greater good of moving the case forward. In exchange for this cost-shifting, estate counsel needs to be able to distinguish clearly between the direction they are getting from the people managing those constituencies who have an interest in the estate (*e.g.,* the DIP, the creditors' committee) and their role (to keep those constituencies focused on their own roles in chapter 11). With counsel for the creditors' committee, any confusion between direction and role is easy to resolve: The creditors' committee is supposed to look out for the interests of the unsecured creditors as a whole, much as the named plaintiffs in a class action must look out for all plaintiffs in that class action. Fall out of line with that role, and it's time to substitute in new players who better understand their role.

DIPs, however, often do not know who the ultimate owners will be. If the estate is hopelessly insolvent, then creditors will end up as the owners. If the estate holds out hope for equity securityholders though, the DIP has to balance the interests of the creditors and the equity securityholders, which is not an easy task. When we say that the DIP is a fiduciary for the estate, then we are saying that the DIP has this constant, guess-where-we-are-at-any-moment balancing act that it has to maintain. Therefore, DIP counsel has the role of looking over the DIP's shoulder to make sure that the DIP takes *its* role as fiduciary for the estate seriously. The DIP, in essence, acts as a placeholder for the myriad interests that the estate comprises. As a mere placeholder, and as a non-disinterested one at that, the DIP can try to look out for the interests of the estate as a whole, but it is DIP counsel who must ensure that the DIP understands its role and acts accordingly. When the DIP either does not understand (or will not perform) its role, it is DIP counsel's duty to rat on the DIP.

What Are DIP Counsel's Duties?

Although two cases have held that DIP counsel owes no fiduciary duty to the bankruptcy estate,[13] the vast majority of courts have held, for a variety of reasons, that DIP counsel owes some form of fiduciary duty to the bankruptcy estate.[14] (Personally, we think that the courts' frustration with how the DIPs in those cases behaved translated into a frustration that DIP counsel could not control their clients behavior.) Unfortunately, these cases have not clearly defined the nature and extent of those duties—probably because the idea of owing fiduciary duites to the estate conjures up the corollary idea of lawsuits by the "estate" against estate counsel. Even though courts have articulated several different aspects of DIP counsel's fiduciary duty,[15] the duty to rat and the related duty that every lawyer has as an officer of the court are the most frequently discussed fiduciary duties in bankruptcy cases. These duties overlap a bit, and we hope that a brief analysis of each of them will provide some guidance as to the scope of DIP counsel's obligations in this area.

Duty to Rat

In the nonbankruptcy world, lawyers agonize over whether they may rat on (*i.e.,* inform) their clients to reveal wrongdoing because the duty to rat conflicts directly with the duty to keep client confidences.[16] Fortunately, the duty to keep client confidences is by no means an absolute duty; nonetheless, when a lawyer concludes that she has to rat on her client, she still must agonize over how much information she is allowed to reveal. Inside the world of bankruptcy, though, it is because DIP counsel really represents the estate *qua* estate and not just the DIP itself that DIP counsel has a clear duty to rat on those running the DIP.[17] Courts have uniformly held that in cases in which management has engaged in misconduct, DIP counsel has the duty to disclose this misconduct in some manner.

The largest problem in this area is determining how serious the misconduct should be before the DIP counsel must disclose it. Although courts haven't articulated an easy, concise test, several courts have noted that DIP counsel can't "close their eyes" to matters having an adverse effect on the bankruptcy estate.[18] Nevertheless, courts have generally required the misconduct to be severe before requiring disclosure. Among the types of misconduct that courts have held must be disclosed are:

7 One of us writes obsessively about this. *See, e.g.,* Nancy B. Rapoport, "The Intractable Problem of Bankruptcy Ethics: Square Peg, Round Hole," 30 *Hofstra L. Rev.* 977 (2002); Nancy B. Rapoport, "Our House, Our Rules: The Need for a Uniform Code of Bankruptcy Ethics," 6 *Am. Bankr. Inst. L. Rev.* 45 (1998); Nancy B. Rapoport, "Seeing the Forest and the Trees: The Proper Role of the Bankruptcy Attorney," 70 *Ind. L.J.* 783 (1995).

8 *See, e.g.,* Fed. R. Bankr. P. 2014; *In re West Delta Oil Co.,* 432 F.3d 347, 355 & n.23 (5th Cir. 2005).

9 *See, e.g.,* Ayer, Clevert, Pelofsky Rapoport & Whyte, Ethics: "Is Distinterestedness Still a Viable Concept? A Discussion," 5 *Am. Bankr. Inst. L. Rev.* 201, 207 (1997).

10 Model Rule of Professional Conduct 3.3, www.abanet.org/cpr/mrpc/rule_3_3.html.

11 *Id.*

12 Model Rule of Professional Conduct 8.4, www.abanet.org/cpr/mrpc/rule_8_4.html.

13 *Hansen Jones & Leta PC v. Segal,* 220 B.R. 434 (D. Utah 1998), *rev'g In re Bonneville Pac. Corp.,* 196 B.R. 868 (Bankr. D. Utah 1996); *In re Sidco Inc.,* 173 B.R. 194 (E.D. Cal. 1994). *Sidco* has probably been overruled by *In re Perez,* 30 F.3d 1209 (9th Cir. 1994).

14 *See, e.g., Brown v. Gerdes,* 321 U.S. 178 (1944) (counsel in bankruptcy cases seeking compensation from court are held to fiduciary standards); *ICM Notes Ltd. v. Andrews & Kurth LLP,* 278 B.R. 117, 126 (S.D. Tex. 2002), *aff'd,* 324 F.3d 768 (5th Cir. 2003); *In re Taxman Clothing Co.,* 49 F.3d 310 (7th Cir. 1995); *In re Perez,* 30 F.3d 1209 (9th Cir. 1994); *In re JLM Inc.,* 210 B.R. 1926 (2d Cir. B.A.P. 1997) (holding both management and debtor's counsel have fiduciary duties to bankruptcy estate in chapter 11 case when debtor's counsel disobeyed new management directions and objected to attempt to dismiss case where new management was unperfected secured creditor seeking to secure its position to detriment of bankruptcy estate). *See also DIP's Attorney, supra* n. 3.

15 Various other duties that courts have stated may be part of DIP counsel's fiduciary duties include: (1) the duty to investigate the debtor and management; (2) the duty to not require debtor to make payments that would endanger a debtor's business operations; (3) the duty to review from bankruptcy estate's standpoint those critical motions filed in a debtor's case; and (4) the duty to police the debtor and its management. *See also DIP's Attorney,* supra n. 3.

16 *See* Model Rules of Professional Conduct 1.6, www.abanet.org/cpr/mrpc/rule_1_6.html.

17 As *Brown v. Gerdes* discussed above, *supra* n. 14, as management of a chapter 11, the DIP's management is clearly not DIP counsel's client, so the attorney-client privilege should rarely be an issue. *See* n. 6, *supra.* In the event there is any significant question as to whether a disclosure would violate the DIP's attorney-client privilege, DIP counsel should consider making a "noisy withdrawal." *See generally* Bowles, "Noisy Withdrawals: Urban Legend or Invaluable Ethical Tool?," 20 *Am. Bankr. Inst. J.* 26 (Oct. 2001) [hereinafter Bowles, "Noisy Withdrawals"].

18 *See In re Food Management Group LLC,* 380 B.R. 677, 708 (Bankr. S.D.N.Y. 2008); *In re St. Stephen's,* 350 East 116th St., 313 B.R. 161, 171 (Bankr. S.D.N.Y. 2004).

a. violation of court orders by insiders. *See, e.g., In re Food Management Group, LLC.,* 380 B.R. 677 (Bankr. S.D.N.Y. 2008).
b. conflicts of interest with another court-approved professional. *See, e.g., In re Sky Valley Inc.,* 135 B.R. 925 (Bankr. N.D. Ga. 1992).
c. refusal to pursue claims against insiders. *See, e.g., In re DeVlieg Inc.,* 174 B.R. 497 (N.D. Ill. 1994).
d. failure to properly market or sell estate assets. *See, e.g., In re Wilde Horse Enterprises Inc.,* 136 B.R. 830, 838 (Bankr. C.D. Cal. 1991).
e. conversion, concealment or misuse of estate property. *See, e.g., In re Ward,* 894 F.2d 771, 776 (5th Cir. 1990); *In re Brennan,* 187 B.R. 135 (Bankr. D. N.J. 1995); *In re Barrie Reed Buick-GMC,* 164 B.R. 378 (Bankr. S.D. Fla. 1994).

The basis of DIP counsel's duty to disclose improper conduct arises from the significant court involvement in both the oversight of the bankruptcy estate and the attorney-appointment process. As noted by the Supreme Court's observation in *Brown v. Gerdes,* attorneys whose retention and fees are subject to court approval are held to a fiduciary standard by that court.[19] The extent of court involvement, akin in part to class action litigation, is different from other nonbankruptcy litigation, where there is little court oversight of the affairs of the litigants outside court. Therefore, the very nature of court oversight of the retention and payment of DIP counsel requires the imposition of the duty to rat on DIP counsel. Our advice? Start off by treating the problem like a MRPC 1.13 (organization as client) problem: Go higher and higher within the DIP to persuade management to do the right thing. If nothing works, then you may have to ask the court to replace management or seek to withdraw as counsel. That should signal a problem without running the risk of over-disclosing confidences. If management opposes these actions, then you may have to disclose more information to the court or—worse yet—suggest the appointment of a trustee.[20]

Duty as an Officer of the Court

Closely related to the duty to rat is an attorney's duty as an officer of the court[21] under the "candor to a tribunal" and other related ethics rules.[22] In the leading case discussing the duties of DIP counsel as an officer of the court, the Fifth Circuit in *In re Ward,* 894 F.2d 771 (5th Cir. 1990), held that an attorney would have to disclose the existence of any concealed assets and possible criminal activity by management that the attorney knew may have taken place.[23] Although this duty to disclose is similar to the duty to rat, all attorneys owe a duty to keep the legal system honest by virtue of their role as officers of the court; this duty does not arise from DIP counsel's fiduciary duty to the bankruptcy estate. As with the duty to rat, however, and given the extent of court involvement with bankruptcy estates, it seems likely that courts will be far more sensitive to an attorney's duty as an officer of the court in the bankruptcy context.[24]

Conclusion: The Law Is the Law

To steal Dave Barry's catchphrase, we are not making this up.[25] We are not making up the fact that representing the DIP is a representation different from other types of representations, even other types of representations paid for out of estate funds. Creditors' committee counsel know that they are always representing the unsecured creditors; only counsel for the hopelessly insolvent DIP can be completely sure that she has no duties to equity as well. We are not making up the fact that management of the DIP can sometimes lose sight of the fact that maximizing and reorganizing the estate, not self-preservation of management's perks, is the point of chapter 11. We do not mean to create an automatic adversarial relationship between the DIP and DIP counsel; most of the time, we expect DIP management to do the right thing and not worry about the risk of DIP counsel's duty to rat. We do mean to say that for those for whom chapter 11 operates not as a handbreak but as a piggybank, DIP counsel must act as an extra check on the integrity of the bankruptcy process. The estate, and all constituents who expect to draw from it, deserve no less. ■

19 321 U.S. at 182.

20 One caveat: State bars often do not understand bankruptcy law. What we are suggesting about a duty to rat might not fly in your home state, even though some states allow disclosure of imminent financial fraud. The fact that your state bar may misunderstand your duty to rat puts you in a precarious position: Fail to rat, and you run the risk of angering the bankruptcy court; rat, and you run the risk of DIP management bringing you before your state bar for a breach of confidentiality. Hey, we never said that bankruptcy law was easy.

21 *See Baker v. Humphrey,* 101 U.S. 494 (1879); *In re Arlan's Dept. Stores Inc.,* 615 F.2d 925, 941 (2d Cir. 1979).

22 For a further discussion of the effect of the Rules of Professional Conduct related to an attorney's obligation of candor to a tribunal, *see generally* Bowles, "Noisy Withdrawals," *supra* n. 148; *see also supra* n. 104-26 and accompanying text.

23 894 F.2d at 776.

24 *See Food Management Group,* 380 B.R. at 709-715, where a bankruptcy court refused to dismiss a lawsuit for breach of fiduciary duty and fraud on the court against DIP counsel seeking damages far in excess of DIP counsel's fees.

25 http://en.wikipedia.org/wiki/Dave_Barry.

A Response: Is It Really a Chapter 11 Debtor Counsel's Duty to Rat?

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In this column, we continue a discussion over the extent to which the chapter 11 debtor-in-possession (DIP) counsel's fiduciary duty to the chapter 11 estate might require the disclosure of confidences or privileges, or what **Chip Bowles** and Prof. **Nancy Rapoport** recently called it in the February 2010 Straight & Narrow column: a "duty to rat."[1] Their article suggested that there were other—and perhaps better—ways to deal with the problem of debtor principals acting or intending to act against the interests of the estate, but ultimately they argued that if all other measures failed, debtor's counsel should be required to disclose. We think this conclusion is questionable.


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The current well-developed ethical structure of Rules 1.6 and 1.13 of the ABA Model Rules of Professional Conduct permits disclosures in certain circumstances (where other remedies have failed), but do not compel it. In our view, this structure sensibly protects the attorney-client privilege, whereas a mandatory disclosure rule would seriously undermine it, thereby undermining the trust and loyalty between an attorney and a client that is so essential to the representation.

Case law trends do appear to strongly support the imposition on debtor's counsel of a fiduciary duty to the estate. However, we believe that neither this fiduciary duty, nor the "exceptionalism" of bankruptcy law and practice, should result in an obligation to break the longstanding traditions and ethical imperatives of attorney-client confidentiality and privilege. Instead, we believe that when confronted with facts indicating that debtor principals are acting contrary to the interests of the estate, debtor's counsel should first exhaust all internal means of overcoming the problem, and if unsuccessful, should withdraw (unless the attorney has concluded, within the rules, that the permitted disclosures should be made). The policy and ethical interests in maintaining attorney-client confidentiality, in our view, demand such a result, and are consistent with the precedent and practice in non-bankruptcy areas.

Straight & Narrow

The Case for Strong Recognition of Attorney-Client Confidentiality

Bowles and Rapoport argue that the exceptionalism of DIP representation, among all other forms of legal representation, might justify a different approach, including the duty to rat. However, this must be balanced against the harm that a permeable attorney-client privilege would cause to the administration of bankruptcy cases. Attorney-client confidentiality is one of the oldest precepts of the legal profession, having originated in Roman law, and it found its way into English case law as early as 1577.[2] This duty of confidentiality between the attorney and client is justified by both professional ideals as well as more pragmatic considerations: In addition to upholding the grand notions of loyalty and trust that embody the very essence of professionalism, courts routinely understand that the purpose of attorney-client confidentiality is to "encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice."[3] In other words, "sound legal advice or advocacy serves public ends and...such advice or advocacy depends upon the lawyer's being fully informed by the client."[4]

We acknowledge that developing law in bankruptcy has done much to muddy the lines of who "the client" is and where DIP counsel's ultimate loyalty rests (if it even rests with any single party). In a commercial case, the client is the corporate debtor and not the individual officers or directors, but the principal officers are the mouthpiece and the brain, and they provide the instructions and directions to counsel. They must expect privilege, and *they* must decide (not the lawyer) whether privilege is to be waived.[5] If the principal officers directing the DIP are not free to address every issue candidly with counsel for the DIP for fear that a disagreement may cause their communications to be disclosed (because counsel has some different duty to the estate), there would likely be severe and adverse effects on the administration of bankruptcy cases. Officers might well conceal information that counsel needs to assure appropriate action for the benefit of the estate. Ultimately, no matter the harm of the information, we believe it is better for it to be provided to counsel where counsel has the opportunity to act on it than to have it concealed for fear that if counsel disagrees it will set off a chain reaction that might lead to disclosure.

Look to the Rules

The obligation for attorney-client confidentiality is embodied by Rule 1.6 of the ABA Model Rules of Professional Conduct, Confidentiality of Information, which states:

1 C.R. "Chip" Bowles, Jr. and Prof. Nancy Rapoport, "Debtor Counsel's Fiduciary Duty: Is There a Duty to Rat in Chapter 11?" 29 *Am. Bankr. Inst. J.* 1 (February 2010).

2 Christopher B. Mueller and Laird C. Kirkpatrick, Evidence §5.8 (3d ed. 2003) (*citing Berd v. Lovelace*, (1577) 21 Eng. Rep. 33 (Ch.); *Dennis v. Codrington*, (1580) 21 Eng. Rep. 53 (Ch.)).

3 *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981).

4 *Id.*

5 *See In re Eddy*, 304 B.R. 591, 599 (Bankr. D. Mass. 2004) (finding that in chapter 11 case that is converted to chapter 7, chapter 7 trustee assumes powers of DIP, including power to waive attorney-client privilege with respect to communications incident to performance of DIP duties).

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Straight & Narrow: A Chapter 11 Debtor Counsel's "Duty to Rat"

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> (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).
> (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
> (1) to prevent reasonably certain death or substantial bodily harm;
> (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;
> (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;
> (4) to secure legal advice about the lawyer's compliance with these Rules;
> (5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or
> (6) to comply with other law or a court order.

Rule 1.6(b)(2) offers a limited exception and permits (but does not require) attorneys to reveal confidential information where a crime or fraud is reasonably certain to result in substantial financial injury. A handful of these situations will be fairly obvious to practitioners as they come across them, and there is little dispute over the most egregious of offenses. That aside, there is a wide range of actions that the DIP can engage in that do not clearly invoke Rule 1.6(b)(2), but may be unfair, not necessarily in the best interests of other parties, or an arguable breach of fiduciary duty to the estate.

Alec Ostrow raised several significant and thought-provoking scenarios in his original article on this subject.[6] Most compelling is his discussion of the issue of chapter 11 motions to convert, dismiss or appoint a trustee. Because such motions require a finding of cause (usually through the DIP's misdeeds or inability for the DIP to effectively govern), this directly implicates a question of the DIP counsel's fiduciary duty.

If there is a mandatory duty to disclose, scenarios like these raise the question of whether a DIP counsel may be breaching its fiduciary duty to the estate if it defends such a motion, while concealing information acquired in confidence that might tend to support the motion. However, so much of what could be within the purview of a motion like this can be said to be a "gray" area. If there were a duty to rat, attorneys would, in many situations, become caught between trying to decide between violating attorney-client confidentiality for an issue falling below the grave harm under Rule 1.6(b)(2) vs. risking liability for a breach of fiduciary duty to the estate.

Climbing the Corporate Ladder, and Withdrawal

The tensions burdening DIP counsel mirror that of the non-bankruptcy, corporate-counsel world. Both DIP and corporate counsel work closely with their respective management groups; in other words, they serve to fulfill the directives set by management. However, they are not the attorneys for the individuals that they work with and receive orders from; instead, they represent a greater constituency. For corporate counsel, the true client is the corporation as a whole.[7]

Consequently, when DIP counsel is cornered with this ethical quandary, we believe that it is best to follow Rules 1.6 and 1.13 of the ABA Model Rules of Professional Conduct. The ethical issues of corporate counsel have existed for a considerable amount of time, and Rule 1.13 reflects a matured compromise over the need to respect attorney-client confidentiality, an attorney's obligation to a greater constituency, and an attorney's own personal ethical obligations. Significantly, Rule 1.13, like Rule 1.6, authorizes (but does not require) disclosure of confidential information in limited circumstances when other efforts to reverse the corporation's intentions and actions have failed. A duty to rat, which would make the disclosure required, seems to go too far, especially where the attorney may withdraw while continuing to protect the important policies of the privilege. Here is the Rule 1.13 Organization as Client:

> (a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.
> (b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances, to the highest authority that can

6 Alec P. Ostrow, "We Don't Need the Case Law to Turn the DIP's Attorney into a Court Informant," 27 *Am. Bankr. Inst. J.* 14 (May 2008).

7 *See* Orly Lobel, "Lawyering Loyalties: Speech Rights and Duties within Twenty-First Century New Governance," 77 *Fordham L. Rev.* 1245 (March 2009).

act on behalf of the organization as determined by applicable law.

(c) Except as provided in paragraph (d), if

(1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

(d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

(e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.

(f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

(g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

The guidance from Rule 1.13 counsels attorneys to internally exhaust all of their advisory options before taking any drastic actions (and on this point Bowles and Rapoport agree). DIP counsel should undertake every opportunity to elevate concerns up the corporate ladder of the DIP in order to dissuade the DIP from engaging in any activity it considers to be objectionable. A lack of responsiveness from managers should be reported even further up the ladder, including approaching the board of directors (or other highest authority).

Should these efforts not succeed, and the highest level of management still insists on a course of action that is objectionable, the best way to balance the competing concerns of attorney-client confidentiality, the fiduciary duties of the estate and an attorney's own personal ethical obligations is through withdrawal. Withdrawal, as provided by Rule 1.16 of the ABA Model Rules of Professional Conduct, allows the troubled attorney to extricate himself from a situation he considers to be objectionable (or that will incur a risk of liability).[8] In this way, DIP counsel can accomplish multiple ethical goals. First, counsel serves its obligation to the relevant stakeholders by not participating in the activity. In addition, such an action sends a strong signal to the DIP that they are entering dangerous territory with their actions. Lastly, such a withdrawal may provide a signal to the court or U.S. Trustee that something is amiss, and that further investigation is necessary—all while still preserving attorney-client confidentiality.[9] ■

[8] Rule 1.16 of the ABA Model Rules of Professional Conduct: Declining or Terminating Representation

(a) Except as stated in paragraph (c), a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if:

(1) the representation will result in violation of the Rules of Professional Conduct or other law;

(2) the lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client; or

(3) the lawyer is discharged.

(b) Except as stated in paragraph (c), a lawyer may withdraw from representing a client if:

(1) withdrawal can be accomplished without material adverse effect on the interests of the client;

(2) the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent;

(3) the client has used the lawyer's services to perpetrate a crime or fraud;

(4) the client insists upon taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement;

(5) the client fails substantially to fulfill an obligation to the lawyer regarding the lawyer's services and has been given reasonable warning that the lawyer will withdraw unless the obligation is fulfilled;

(6) the representation will result in an unreasonable financial burden on the lawyer or has been rendered unreasonably difficult by the client; or

(7) other good cause for withdrawal exists.

(c) A lawyer must comply with applicable law requiring notice to or permission of a tribunal when terminating a representation. When ordered to do so by a tribunal, a lawyer shall continue representation notwithstanding good cause for terminating the representation.

(d) Upon termination of representation, a lawyer shall take steps to the extent reasonably practicable to protect a client's interests, such as giving reasonable notice to the client, allowing time for employment of other counsel, surrendering papers and property to which the client is entitled and refunding any advance payment of fee or expense that has not been earned or incurred. The lawyer may retain papers relating to the client to the extent permitted by other law.

[9] *See also* Bowles, "Noisy Withdrawals: Urban Legend or Invaluable Ethical Tool?," 20 *Am. Bankr. Inst. J.* 26 (October 2001).