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Do This, Not That: Ethics Roundtable

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CONCURRENT SESSION

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The Do This, Not That of Bankruptcy Ethics

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The Do This, Not That of Bankruptcy Ethics

"The integrity of the bankruptcy system, indeed the entire legal system, is dependent in large part on the ethical conduct of lawyers, their adherence to the law, and their compliance with the rules of the courts before which they appear." *In re NNN 400 Capital Center LLC,* 16-12728 (Bankr. D. Del. Sept, 4, 2020).

Like all attorneys, bankruptcy attorneys are subject to all the rules of professional conduct. In addition, Bankruptcy attorneys can be sanctioned for violations of the Bankruptcy Code or the Federal Rules of Bankruptcy Procedure. Bankruptcy attorneys must not lose sight of the forest for the trees. In other words, attorneys must focus on the big picture to ensure they are following all rules governing their conduct.

In addition to the ethical obligations of all attorneys, Courts have identified modern issues that present ethical dilemmas for those attorneys who practice bankruptcy. Bankruptcy caselaw attempts to help guide attorneys through the DO's and DON'T's of practice in the area. Along with the rules of professional conduct, there are a few specific ethical updates that every bankruptcy practitioner should be aware of: 1) disinterestedness requirements and retaining professionals; 2) potential for malpractice involved with waiving Stern objections; 3) improper advice for client's on forms of payment; 4) improper use of Appearance of Counsel; 5) candor to the court and interested parties; and 6) disciplinary sanctions.

Do's and Don'ts: Model Rules of Professional Conduct

General Rules

The Model Rules of Professional Conduct are the rules that most states implement to govern attorneys' ethical obligations. Some states use the Model Rules as guides when crafting their own rules applicable to the attorneys practicing within their state. Therefore, any rules discussed will be referred to and cited herein as their Model Rule counterpart to ensure a universal discussion. The rules that are often regarded as the most important are those contained within Rule 1. These rules include rules governing competence, scope of representation, and conflicts of interests. Another rule that speaks to the fiduciary duties owed to clients is Model Rule 2.1 mandating attorney's use their independent judgment without bias.

Focusing on general disinterestedness, **Model Rule 1.8** provides as follows:

> A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:
>
> (1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;
>
> (2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and
>
> (3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

All attorneys must ensure their practice follows the rules governing conflicts of interest so as to avoid a breach of fiduciary duties.

Don't do this: Lose the Forest for the Trees

Most attorneys learn the ethical obligations they face in law school or in studying for the ethics portion of their respective bar exams. Rules governing conflicts of interest are rules that attorneys and courts take very seriously. Attorneys have a fiduciary duty to ensure that they are not making decisions clouded by their own interests.

Attorneys who violate these rules are subject to sanctions either by the Bankruptcy Court under Section 105(a) of the Bankruptcy Code, Federal Rules of Bankruptcy Rule 9011, or by a State's Disciplinary Board. Among these attorneys is one attorney who was sanctioned by a panel of the Kansas Board for Discipline of Attorneys.

After a hearing and appeal, it was determined that the Attorney, Mark D. Murphy violated Kansas' equivalent to Model Rules 1.1 (competence); Rule 1.2(c) (scope of representation); 1.7 (conflict of interest); 2.1 (independent judgment; and 8.4(d) (conduct prejudicial to the administration of justice).

Murphy had a professional and personal relationship with someone referred to as SF. SF was Murphy's neighbor who owned a business (BC) that helped companies raise capital. SF referred one of their clients, a soccer club, to Murphy to help conduct a transaction where one of the soccer club's owner would raise money for the soccer club by selling a limousine company he owned at the time.

Murphy helped the soccer club draft a shareholder agreement with the partners of the club. At this time, the owner of the soccer club whom owned the limousine company filed Chapter 7 bankruptcy. As a part of the estate, the owner listed the limousine company as part of his assets.

Two months after the owner of the soccer club filed the bankruptcy listing the limo company as an asset, Murphy was called upon to help guide the transaction to sell the limo company. Murphy drafted an engagement agreement which indicated that he represented both the seller and the buyer and would advise the parties as needed on the transaction. However, the buyer was unaware that the seller had filed bankruptcy just two months earlier. The buyer was also unaware that the limo company was a part of the bankruptcy estate at this time. Murphy represented both parties without instructing them on the conflict of interest present, which was the first red flag.

As if the conflicts here were not enough, the limo company was actually the property of the bankruptcy trustee at the time of the transaction. The seller's representations during the transaction were replete with inaccuracies about the limo company's profitability and current financial and legal position. The limo company had actually lost its charters for failing to follow corporate formalities.

Further, the purchase agreement was formatted as a stock purchase agreement. The limo company had never issued any stock. The agreement referred to some sixteen (16) documents that were not only not attached to the agreement, but also non-existent. After some time, during negotiations, the buyer found out about the misrepresentations and the bankruptcy.

After the bankruptcy came to light, Murphy did not stop the transaction, but rather attempted to restructure the agreement to get around the bankruptcy proceedings. The restructuring changed from a stock purchase agreement to treating the agreement as if it were a purchase for the limo company's services.

It gets better, Murphy did not withdraw from representation. The seller of the limo company then called a bankruptcy attorney after recommendation from Murphy. The bankruptcy attorney informed the seller that he must let his bankruptcy attorney know about this situation so the trustee could be informed.

The seller informed his bankruptcy attorney, but only as to the second agreement which was structured as a sale for services. The bankruptcy attorney then forwarded on the information surrounding the transaction to the trustee with the copy of the service agreement. The trustee reviewed the agreement and stated that the agreement did not seem to be a part of the estate.

After the transaction went through, the buyer realized that the misrepresentations were much larger than originally thought. The profitability was not as represented by the seller and Murphy had in no way informed him of this risk.

After a malpractice suit was filed and the disciplinary board became involved, Murphy was found to have violated several of the Kansas Rules of Professional Conduct. Specifically, for:

1. the lack of knowledge, skill, thoroughness, and preparation reasonably necessary for the representation (1.1 Competence);
2. for failing to obtain consent from the parties limiting representation to only acting as a "scrivener" of the transaction and not legal counsel (1.2(c) scope of representation);
3. for failing to take measures necessary to allow for representation of parties who adversely affect one another (1.7 conflict of interest—adverse parties);

4. for failing to exercise independent professional judgment and failing to offer candid advice after learning of the bankruptcy (2.1 independent professional judgment); and
5. for attempting to circumvent the bankruptcy proceedings by restructuring the agreement (8.4(d) conduct prejudicial to the administration of justice).

After considering all factors relevant to the imposition of sanctions, Murphy was suspended from practice within the state for two years.

Do this: Keep Updated on ALL Governing Rules of Ethics

Murphy's misconduct shows how an attorney might be sanctioned not only by a state's disciplinary board, but also the bankruptcy court. Attorneys must realize there are repercussions for unethical conduct. An attorney's license is at stake with each and every decision they make on behalf of their client.

Attorneys must ensure they obtain appropriate waivers, but also understand when to withdraw from representation. The engagement agreement at issue explicitly indicated if a conflict arises between the parties, the parties would have to retain counsel independently to resolve this issue. Had Murphy followed that, he may have been better off and avoided sanctions. Murphy had a further chance to avoid sanctions when he was presented with the issue of the bankruptcy. This was a red flag in the transaction that may have put Murphy on notice that perhaps independent representations would be needed. Instead, he proceeded to attempt to circumvent the bankruptcy proceeding by fraudulently representing the transaction to be for services, which it was not. Ultimately, Murphy should have known when to back down from the representations.

Do's and Don'ts: Disinterestedness and Disclosures; and Retaining Professionals

General Rules

Further, the disinterestedness test is an accumulation of Federal Rule of Bankruptcy Procedure Rule 2014(a) and 11 U.S. Code Section 327(a). **Rule 2014(a)** provides as follows:

> (a) APPLICATION FOR AND ORDER OF EMPLOYMENT. An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to §327, §1103, or §1114 of the Code shall be made only on application of the trustee or committee. The application shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States trustee. The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. The application shall be accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.

Nowhere in Rule 2014(a) is there guidance on the word "connection." There is no seeming limitation on the term within the statute, but courts typically rely on practical application. Rule 2014(a) requires a professional seeking authorization of the court to be employed, to disclose its connections to the debtor, its creditors, and any party in interest. Section 327(a) of the Bankruptcy Code is considered "the gatekeeper" which, on its face, authorizes retention of disinterested professionals. Courts use these disclosures to gauge whether the person to be employed is not disinterested or holds an adverse interest. *See In re Renaissance Residential of Countryside, LLC*, 423 B.R. 848, 857 (Bankr. N.D.Ill. 2010).

Adverse interest is generally recognized where the attorney either: "possess[es] or assert[s] any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant" or "possess[es] a predisposition under circumstances that render such a bias against the estate." *In re AroChem Corp*., 176 F.3d 610 (2d Cir. May 18, 1999).

Aside from disinterestedness, there is a disclosure requirement for fee arrangements. Section 329(a) and Federal Rule of Bankruptcy Procedure 2016(b) together govern the disclosure requirements for any fee arrangements. These regulations present a "check" on debtors' attorneys to disclose fee arrangements and payments.[4] The two together require disclosure within 14 days of the order for relief of all fee arrangements and payments within one year of filing, and disclosure of all payments made within 14 days. A violation of these requirements can lead to disgorgement of fees and courts treat these violations as seriously as a breach of fiduciary duties.

Federal Rules of Bankruptcy Procedure 2017(a) implements Section 329 by providing that the court on its own initiative or any party in interest can motion the court to review the debtor's attorney fees for excessiveness. Congress enacted these sections in recognition of the fact that "[p]ayments to a debtor's attorney provide serious potential for evasion of creditor protection provisions of the bankruptcy laws, and serious potential for overreaching by the debtor's attorney, and should be subject to careful scrutiny". S.Rep. No. 989, 95th Cong., 2d Sess. 39 (1978).

[4] *See Futuronics Corp. v. Arutt, Nachamie & Benjamin (In re Futuronics Corp.),* 655 F.2d 463, 470 (2d Cir. 1981); *see also SE Properties Holdings LLC v. Stewart (In re Stewart)*, 19-6103 (10th Cir. Aug. 14, 2020).

Once the court on its own initiative or party interest raises the question of the reasonableness of the attorney fees under Section 329, the debtor's attorney bears the burden of proving his/her fee is reasonable. The factors used to evaluate the reasonableness of the compensation are set forth in Section 330(a)(3) of the Bankruptcy Code and require a court to "consider the nature, extent, and value of such services, taking into account all relevant factors", including the time spent on the services, rates charged; whether the services were necessary to the administration of or were beneficial to a case; whether the services were performed in a reasonable amount of time; and the customary compensation of comparably skilled attorneys in other cases. An attorney's failure to justify the reasonableness of their fee can results in sanctions and disgorgement of their fees. Often times the fees are returned to the debtor or bankruptcy estate, if the property transferred would have been property of the bankruptcy estate. Most often if the fee is paid pre-petition it will be considered property of the bankruptcy estate.

Don't do this: Lessons from Recent Caselaw on Conflicts of Interest

A recent scenario involving McKinsey & Company law firm comes to mind. The McKinsey law firm recently reached a $15 million settlement to end the investigations with the US Trustees Program. McKinsey, a bankruptcy consulting firm, was accused of hiding potential conflicts.[5] A part of the settlement consists of creating a protocol for disclosures.

In *In re NNN 400 Capital Center LLC,* 16-12727 (Bankr. D. Del. Sept. 4, 2020), the US Trustee brought to the Court's attention that Rubin & Rubin, Debtor's counsel, represented

[5] *U.S. Trustee Program Reaches $15 Million Settlement with McKinsey & Company to Remedy Inadequate Disclosures in Bankruptcy Cases*, www.justice.gov, https://www.justice.gov/opa/pr/us-trustee-program-reaches-15-million-settlement-mckinsey-company-remedy-inadequate (Feb. 19, 2019).

the Debtor's property manager. The representation surrounded a transaction of a building that Debtor had an ownership interest in. The property manager was one of the largest unsecured creditors in Debtor's bankruptcy. Debtor's counsel did not disclose the representation in its supplemental disclosures, even after being sanctioned for other disclosure violations.

Do this: Use a Well-Defined Protocol from the Outset

The protocol within the McKinsey settlement is known as the Baker/Singerman Protocol. The purpose of protocols like this is to provide the court and interested parties with a reasonable basis from which to determine if the proposed professional will be able to provide unbiased advise.[6] Specifically, the Baker/Singerman Protocol defines connection as, "an association or relationship with an [interested party in a case] that a reasonable person might find bears on whether the proposed Professional 'holds or represents an interest adverse to the estate' and is 'disinterested' under [the relevant provisions of the bankruptcy code], based on the facts of a particular bankruptcy case." This definition seems to come directly from prevailing precedent; however, the definition does not cite specific caselaw.

Bankruptcy courts continue to attempt to make sense of the vague statutory disinterestedness requirements within Federal Rule of Bankruptcy Procedure Rule 2014(a) and Section 327(a) of the Bankruptcy Code. The use of protocols in retaining professionals helps guide professionals in following these obligations.

[6] *Professionals Should Not Be Held To A Higher Standard Than Judges* by Ronald Barliant (a former judge in the Norther District of Illinois).

A protocol can help limit the disclosure requirements to those that might reasonably be thought to evidence a real problem. This is essential because *de minimis* connections need not be disclosed because they are not going to lead to the materially adverse interest that is the focus of the Bankruptcy Code's disinterestedness requirement. The disinterested standard does not only apply at the outset or at the time of retention, this duty is ongoing. The requirement mandates strict adherence, often requiring formal supplemental disclosures. See Bankruptcy Code Section 328(c).

Don't do this: Fail to Disclose Fee Arrangements

Courts have set clear standards for sanctions when violating Section 329(a) in failing to properly disclose fee arrangements.[7] Specifically, the Tenth Circuit was faced with an appeal of a disgorgement of fees in *In re Stewart*. The debtor's attorney in *In re Stewart* failed to disclose a fee arrangement. One of the largest creditors challenged this disclosure in court, seeking an imposition of sanctions on debtor's counsel.[8] The creditor realized the failure to disclose almost two years after the fee agreement as made and one year after the payment. The Creditors are rightfully concerned, as this can lead to a lower pro rata distribution and some creditors may not even be paid at all. Tenth Circuit noted that the failure to make proper attorney disclosures should be taken as seriously as a breach of fiduciary duty.

The Tenth Circuit cited decisions from several circuits insisting that attorney's compensation is scrutinized more closely, and an oversight is a significant concern. The Court further noted that creditors can be denied their proper share of the estate. In quoting

[7] *See Futuronics Corp. v. Arutt, Nachamie & Benjamin (In re Futuronics Corp.)*, 655 F.2d 463, 470 (2d Cir. 1981); *see also SE Properties Holdings LLC v. Stewart (In re Stewart)*, 19-6103 (10th Cir. Aug. 14, 2020).
[8] *Id.*

a decision out of the Eighth Circuit Bankruptcy Appeal Panel, the *In re Stewart* Court asserted that §329 "reflects Congress' concern that payments to attorneys in the bankruptcy context might be the result of evasion of creditor protections and provide the opportunity for overreaching by attorneys."[9]

Ensuring compliance with all disclosure requirements is critical. Any violation of the heighten ethics requirements, including a failure to disclose fee arrangements pursuant to § 329 and Federal Rule of Bankruptcy Procedure Rule 2016(b).

As if failing to disclose representation of a creditor wasn't enough, debtors counsel in *In re NNN 400 Capital Center LLC,* 16-12727 (Bankr. D. Del. Sept. 4, 2020), was retained prior to their bankruptcy filings to help evaluate a potential to restructure their ownership interests in an office building. The loan was needing refinancing and the loan ended up defaulting. The Debtors filed for bankruptcy. Debtors' counsel then hired a "finder" to assist with identifying a refinancing lender. *Id.* While there was no formal agreement between the attorney and the "finder," there were several emails memorializing their agreement. The "finder" would end up retaining 1% for the loan amount as commission. *Id.* Further, half of the commission was payable to the attorney for securing the loan. *Id.* There was a similar agreement with the same "finder" post-bankruptcy. The agreements are likely to create a system of favoritism due to the fee arrangements with the "finder" and attorney. This could greatly impact their desire to use the "finder" no matter the terms of the financing. In these arrangements, the losing party is the debtor.

[9] *In re Reading*, 263 B.R. 874, 878 (B.A.P. 8th Cir.).

The attorney argued that they had no obligation to disclose the agreement with the "finder." Under Fed. R. Bankr. P. 2014(a), disclosure was necessary. "The professional must disclose ***all*** connections and potential connections." *Id.* (citing *In re Universal Bldg. Products*, 486 B.R. 650, 653 (Bankr. D. Del. 2010). The Court noted that the rules demand full compliance and when the strict standards have not been met, sanctions are imminent. *Id.*

Do this: Over-Disclose Fee Arrangements

The Rules of Bankruptcy are designed to protect Debtors and ensure attorneys are not taking advantage of their client. Any failure to disclose will likely result in sanctions ranging from less severe suspensions to full disgorgement or disbarment. Any violations of the rules cast a cloud of impropriety over the parties who have failed to properly disclose. Fee arrangements are no exception. In fact, failing to disclose fee arrangements may prompt a court to delve further into disclosures to determine whether impropriety exists.

Debtor's counsel should disclose all connections or agreements made. There is no requirement that the agreement be formalized. Email was enough for the court *In re NNN 400 Capital Center, LLC*. Even when there may be a question as the requirements, erring on the side of disclosure is likely to avoid potential for sanctions after the fact.

Don't do this: Enter into Settlement Agreements, then Disregard the Terms

In a decision out of the Eleventh Circuit earlier this year, sanctions of $150,000 were upheld against UpRight Law. *Law Solutions of Chicago LLC v. Corbett*, 19-11405 (11th Cir. Aug. 21, 2020). UpRight Law acts like a referral agency based in Chicago which refers clients to local bankruptcy counsel. *Id.* The attorneys, while titled "partners," have no actual affiliation with UpRight aside from the referral relationship.

The "partner" working with UpRight in Alabama was a Birmingham attorney. *Id.* Ms. The partner represented debtors in two Chapter 7 cases in the Northern District of Alabama. The disclosures from Ms. Morrison indicated that the clients paid UpRight a flat fee which covered basic bankruptcy representation. However, certain services were deemed excluded. *Id.* The Bankruptcy Administrator brought two adversary proceedings alleging ethical violations against UpRight specifically. *Id.* As a result, the Bankruptcy Administrator, mediated with UpRight. Pursuant to the settlement agreement UpRight would, among other sanctions, have to provide excluded services referred to in their standard client retention agreement without additional charges. *Id.* The Bankruptcy Court reviewed and approved the settlement agreement. *Id.*

Less than a year later, UpRight filed six Chapter 7 cases which failed to meet the terms of the settlement agreement. UpRight's attorney disclosures contained retention agreement with the two clients requiring the further fees for excluded services. *Id.* After the Bankruptcy Administrator filed a motion to show cause, UpRight filed amended disclosures changing the terms to be consistent with the settlement.

UpRight Law was a national consumer firm which qualified as a debt relief § 528(a). Debt relief agencies must provide clients with a written contract "clearly and conspicuously" explaining services provided to the client and the charges for such services. *See* § 528(a). If the debt relief agency is found to have intentionally violated their requirements under the statute, they are subject to penalties as deemed fit by the Bankruptcy Court. *See* § 526(c)(5).

Due to the unsettling nature of the disclosures, the Bankruptcy Court reiterated from the lower court that "they repeatedly violated basic requirements of the Bankruptcy Code

and Rules applicable to attorneys and debt relief agencies." *Id.* The Court further repeated from the lower court holding that their practices were questionable, and they ignored their obligations under the settlement. The Eleventh Circuit acknowledged that the misleading nature of their retention agreements found within the attorney disclosures could have a "chilling effect that the exclusionary language necessarily imposed on cash-strapped debtors who may have been in need of further representation they could not afford." *Id.* However, the Eleventh Circuit noted that the lower court may have been harsh, but they were not out of line and the sanctions should stand. *Id*.

Do this: Maintain Oversight to Ensure Compliance

Due to the nature of UpRight, the firm lacked oversight over partners. There was no one to hold the partners accountable. UpRight was ultimately the one entering into settlement with the Bankruptcy Administrator, but the partner who was licensed in Alabama practiced in the Northern District of Alabama. It was the Alabama partner's actions which the Bankruptcy Administrator sought to deter. UpRight entered into an agreement to change their partner's behavior, when in reality, they were simply a referral service for the attorney who had filed the cases.

UpRight should not have entered into the settlement agreement when they were unable to control the retention agreements and attorney disclosures. UpRight further did not have oversight or control over fulfilling the agreement by ensuring the excluded services were provided to clients without the extra attorney's fees.

Long story short, do not put yourself in front of the fire unless you can control the fire! UpRight set itself up for failure and was reprimanded. In the initial settlement

agreement, upright agreed to pay $25,000 per bankruptcy case. Now, the firm would be responsible for the same amount to each of the six cases filed in violation of the settlement agreement's terms.

Don't Do This: Sanctions for Failure to Disclose

Bankruptcy courts will not hesitate to exercise their authority to sanction under Section 105(a) of the Bankruptcy Code when professionals fail to disclose connections that might foreclose a professional from retention. "Full disclosure serves a crucial role in the professional being paid" (citation omitted). *In re Midway Industrial Contractors, Inc.*, 272 B.R. 651, 662 (Bankr. N.D.Ill. 2001). In fact, failure to disclose is sufficient grounds to revoke an employment order and deny compensation. *See In re Raymond Professional Group, Inc.*, 421 B.R. 891, 906 (Bankr. N.D.Ill. 2009).

A case that expansively illustrates complexities and limitations on the disinterestedness requirement is *In re Relativity Media*, No. 18-11358 (MEW), 2018 Bankr. LEXIS 2037, at *3-4 (Bankr. S.D.N.Y. July 6, 2018). In *In re Relativity Media*, an objection was raised as to the retention of Winston & Strawn LLP. Debtors sought to retain Winston & Strawn LLP (the "Firm") as attorneys for debtors pursuant to Section 327(a). Winston & Strawn disclosed through a declaration that the firm, at the time of that declaration, was acting as counsel for Netflix, Inc. in patent litigation pending in the United States District Court for the District of Delaware. Netflix was a creditor to Relativity (the "Debtor") seeking to retain the Firm. Two objections were raised with regard to the retention of the Firm. First, Netflix argues that the Firm's representation of the Debtor would violate obligations owed to Netflix. Second, the Office of United States Trustee filed objection arguing that retention

of the Firm is entirely barred by Section 327. The United States Trustee explained that firms should not be able to drop current client's in order to avoid conflicts based on concurrent representations. The Trustee dubbed this the "hot potato" approach to the ethical obligation of loyalty. The Trustee insisted that a firm should not be permitted to solve the problem by just withdrawing from one of the two client's representation.

The Court was not convinced by the Trustee's argument. The Court pointed to Section 327(c) explaining that a firm is not disqualified "solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the US Trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest." *Id.* at 6. The Court says this is not the case here because there are other fundamental proceedings in bankruptcy that are to be accomplished and the issue with Netflix is separate and distinct from those proceedings. *Id.* The Court asserts that "[t]here is nothing about those general tasks that is adverse to Netflix at all and no respect to which [the Firm]'s independence or loyalty would be altered in performance of that work as a result of its separate work for Netflix…"

Do This: Know When Conflicts May Prevent Representation

The result was that the Firm would be required to hire special counsel to represent the Debtor in proceedings adverse to Netflix. The Court essentially used special counsel to ensure disinterestedness in this case.

Do's and Don'ts: Waiving Stern Objections and Avoiding Malpractice

Background on Stern Objections

Another recent ethical issue came to light as a result of *Stevens v. Sharif*, No. 15 C 1405, 2017 U.S. Dist. LEXIS 14258, at *19 (N.D. Ill. Feb. 2, 2017), where the United States District Court for the Northern District of Illinois grappled with whether the failure to raise a Stern Objection could result in an attorney's liability for malpractice

In *Stern v. Marshall*, 131 S. Ct. 2594 (2011), the Supreme Court held that the bankruptcy courts lack constitutional authority to issue a final judgment on a state law counterclaims asserted against a creditor. The Supreme Court later held that an Objection to the power of the bankruptcy court to enter a final order, (a "Stern Objection") can be waived. *Wellness International Network Ltd. v. Sharif*, 135 S. Ct. 1932 (2015).

Don't Do This: Implicit Waiver of Stern Objections

In *Sharif*, the client sued his attorney, Stevens, for malpractice. Initially, the client's own misconduct in discovery prompted the district court to enter summary judgment in favor of Wellness International and against the client for a $650,000 judgment. It was this judgment that caused the client to file bankruptcy. Due to the discovery abuses, the bankruptcy court entered judgment against the bankrupt client. The lawyer appealed to the district court but did not raise a Stern Objection until he brought it up after the fact, in a supplemental brief. The district court on appeal found that the Stern Objection was effectively waived. Then, the attorney appealed to the Seventh Circuit. The attorney again did not raise the Objection until a reply brief. On remand, the Seventh Circuit held that the Stern Objections were waived because they had not been raised in a timely manner. *Wellness International Network Ltd. v. Sharif*, 135 S. Ct. 1932 (2015).

During the malpractice suit in *Stevens*, the Court found that the failure to raise the Stern Objection violated the standard of care imposed on the lawyer and was therefore malpractice! However, the lawyer in this case escaped liability because the Court found no proximate cause existed between the waiver and the client's damages. Essentially, the court in the initial suit would have ruled the same way had the attorney properly raised the Stern Objection.

Do This: Knowing Waivers

For insulation from malpractice, a lawyer should document the client's fully informed waiver. This should be in writing and should be obtained from the outset.

Do's and Don'ts: Advising Clients as to Form of Payment

General Rules

Bankruptcy Code Section 526(a)(4) warns:

> A debt relief agency shall not… advise an assisted person or prospective assisted person filing a case under this title or to pay an attorney or bankruptcy petition preparer a fee or charge for services performed as part of preparing for or representing a debtor in a case under this title.

Further ethical guidance for practitioners was given by the Supreme Court in reliance on Section 526(a)(4), when the Court held that a lawyer cannot advise a client to incur debt in contemplation of bankruptcy when the debt is incurred for an improper purpose. *Milavetz, Gallop & Milavetz PA v. US*, 559 U.S. 229 (2010). However, the Eleventh Circuit recently picked apart the Supreme Court's test and held that an attorney should not advise a client to pay for their attorney's fees by the use of a credit card.

Don't Do This: Affirmatively Advising Clients to Use a Credit Card for Payment

The Supreme Court in *Milavetz, Gallop & Milavetz PA v. US*, 559 U.S. 229 (2010), applying Section 526(a)(4) held that a lawyer is prohibited from advising a client to incur more debt in contemplation of bankruptcy only when the debt is being incurred for an improper purpose. *Id.* Following the spirit of *Milavetz*, the Eleventh Circuit established that Section 526(a)(4) prohibits an attorney from affirmatively advising "a client to incur additional debt to pay for bankruptcy-related legal representation, without respect to whether the advice was given for some independently 'invalid purpose.'" *Cadwell v. Kaufman, Englett & Lund* PLLC, 17-10810 (11th Cir. March 30, 2018). While the construction of the language leaves room for interpretation, the Court held that the Eleventh Circuit adopts the reading that the statute should be recast to prohibit "advice 'to incur debt' either (1) 'in contemplation of' a bankruptcy filing or (2) 'to pay an attorney' for bankruptcy-related services." *Id.* This interpretation ensures that there are no "goofy results, defy[ing] the usual rules of syntax, or render[ing] a phrase meaningless." *Id.*

Do This:

Don't advise clients to pay for attorneys' fees by credit card or loan.

Do's and Don'ts: Appearance Counsels

Background on Appearance Counsel in Bankruptcy

Courts have also had trouble with the concept of Appearance Counsel, defined as attorney who appear at proceedings at the request of, and on behalf of, the debtors' chosen attorney. *See In re Bradley*, 495 B.R. 147, 757 n.1 (Bankr. S.D. Tex. 2013). Bankruptcy Courts have had trouble accepting the use of Appearance Counsel due to the complexity of

bankruptcy proceedings. *In re D'Arata*, 18-10524 (Bankr. S.D.N.Y. Aug. 3, 2018). In fact, in *In re D'Arata*, the Southern District of New York held that the use of Appearance Counsel in some circumstances can be an ethical violation and resulting in the disgorgement of attorney's fees pursuant. *Id.*

Appearance Counsels may work in other practice areas, but courts insist that bankruptcy is the exception. *See In re D'Arata*, 18-10524 (Bankr. S.D.N.Y. Aug. 3, 2018). In *In re D'Arata*, a Debtor had a slew of problems with bankruptcy filings including incorrect information and falsified signatures in the Petition and Schedules. However, the Court was particularly interested in the Debtor's counsel using Appearance Counsel in both attempts at the 341 Meetings. *Id.*

Don't Do This: Hire Incompetent Appearance Counsel for 341 Meetings

In *In re D'Arata*, the Debtor wrote letters to the judge complaining about his attorney, who he paid $900 to retain. The letters voiced the issues with the Petition and Schedules, but also indicated that the attorney did not attend the initial 341 Meeting. Instead, the attorney sent an Appearance Counsel. *Id.* This Counsel had not had any details of the case, did not work for the retained attorney's firm, and only met the Debtor that day. Due to the issues the Debtor had with the Schedules, the Meeting was continued. *Id.*

When the second attempt at the 341 Meeting came about, not only were the errors not corrected, but the retained attorney sent a second Appearance Counsel. Similarly, this Counsel had not had any details of the case, did not work for the retained attorney's firm, and only met the Debtor that day. *Id.* The Court held that sending Appearance Counsel to the 341 Meeting actually "left the debtor without representation at the meeting(s) of creditors."

Id. Neither of the Appearance Counsels were consented to by the Debtor, and the Debtor was only aware of the first Appearance Counsel's role. The Court applied Section 329(b),

> [if] such compensation exceeds the reasonable value of any such services, the court may cancel any such agreement, or order the return of any such payment, to the extent excessive, to… (2) the entity that made such payment."

The Court found that nothing was accomplished in furthering the Debtor's bankruptcy proceedings. So, the retained attorney was ordered to disgorge the $900 fee. *Id.*

Do This: Consider Perils of Using Appearance Counsel Prior and Ensure Competence

The Court in *In re D'Arata* pointed out the several perils of Appearance Counsel in bankruptcy proceedings. Specifically, these attorneys are not generally disclosed to the Court or to the Trustee. *See In re Bradley*, 495 B.R. 747, 757 n.1 (Bankr. S.D. Tex. 2013). This typically raises questions about their representation of the Debtor and their authority in the proceedings. *Id.* Most importantly, the improper use of Appearance Counsel can "frustrate the negotiation and communication process among the debtor, the creditors, and the trustee." *Id.* Long story short, avoid using Appearance Counsel in bankruptcy, especially for the 341 Meetings.

Do's and Don'ts: Candor to the Court and Interested Parties

A core part of bankruptcy proceedings is transparency. This transparency is especially important to the courts and to interested parties. Disclosing claim assignments became an issue in recent caselaw. *In re Bavelis*, 18-3149 (6th Cir. Nov. 19, 2018). In *In re Bavelis*, the failure to disclose claim assignment to another party was deemed, "egregious,

bad-faith conduct" and constituted "unreasonable and vexatious litigation tactics… warranting imposition of sanctions under section 1927." *Id.*

Don't Do: Hidden Assignments

In *In re Bavelis*, Quick Capital filed a proof of claim against a bankruptcy estate based on a $14 million note. This claim was then sold by Quick Capital for $1.8 million to Socal, an unrelated entity. Quick Capital's attorney agreed not to disclose the sale or assignment of the claim to the Debtor or the Court. Throughout the case, Quick Capital posed as the "creditor" and litigated the entire case as if they were the interested party… for two years. The attorney and company failed to mention the assignment in several discovery requests, even when prompted to do so. Further Quick Capital filed documents failing to disclose the assignment and misrepresented that Quick Capital remained a creditor of the bankruptcy estate post-assignment.

All in all, Quick Capital followed one ethical misstep with another, time after time, including:

- Filing the Proof of Claim, then assigning it to another entity;
- Remaining on the case as a creditor;
- Agreeing to keep the assignment confidential;
- Failing to disclose the assignment in discovery; and
- Affirmatively misrepresenting their status in the assignment

The Court ended up sanctioning counsel under 28 U.S.C. Section 1927 which states:

> "Any attorney… who so multiplies the proceedings in any case unreasonably and vexatiously may be required by the court to satisfy personally the excess costs, expenses, and attorneys' fees incurred because of such conduct."

Pursuant to this statute, the failure to disclose claim assignment resulted in counsel paying substantial fees in the amount of $250,000, to compensate for the unnecessary costs and fees spent by the Debtor throughout the proceedings.

Do This: Be Candid with the Court

Candor to the court ensures transparency, which is what bankruptcy is all about. In this situation, Quick Capital had many opportunities to remedy their mistake, but this could have been solved by simply filing an assignment. Attorney and all parties should remain candid with the court and interested parties.

Do's and Don'ts: Disciplinary Sanctions

General Rules

Anytime an attorney is faced with disgorgement of fees, **total** disgorgement of fees is the default sanctions. *In re Stewart*, 19-6103 (10th Cir. Aug. 14, 2020).

Bankruptcy Code Section 523(a)(7)(A) provides exceptions for dischargeable debts. This carve out applies to debt "to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental and is not compensation for actual pecuniary loss…"

Don't Do This: Fail to Properly Present Mitigating Circumstances

In *In re Stewart*, a lower court found that partial disgorgement was appropriate, relying on her own experience in the bankruptcy field and her knowledge of the debtors' counsel faced with sanctions. However, the Tenth Circuit was quick to overturn the conclusory holding.

The Tenth Circuit noted that when faced with disgorgement, total disgorgement of all fees is the default sanction. However, the Court implied that mitigating circumstances might be considered. The lower court had not relied on the record in deciding to issue sanctions for only part of the attorney's fees. The lower court's decision mentioned that a total disgorgement would be a financial catastrophe for the solo practitioner and that a partial disgorgement would be an appropriate penalty and would prevent any similar misconduct in the future. While mitigating factors may have been present, the attorney failed to record of these circumstances, leaving the Tenth Circuit with a record deplete of any sound reason to reduce the disgorgement. In reversing the partial disgorgement, the Tenth Circuit noted that total disgorgement "should be the default sanction, and there **must be sound reasons for anything else."**

Do this: Hire Counsel to Present Mitigating Factors to the Court

When faced with potential disgorgement, attorneys should not rely on their own experience. Attorneys should appropriately hire an attorney to defend themselves. This attorney should create a clean record. Where mitigating circumstances exist that give a court sound reason to reduce the disgorgement from total to partial, ensure the evidence is on the record. This ensures that if the judge does issue sanctions, an appellate court can cite to the record and uphold the reduction, as oppose to being forced to reverse for the default sanction, a total disgorgement of fees.

Don't Do This: File Bankruptcy After Penalties

In *In re Albert-Sheridan*, the Bankruptcy Appellate Panel for the Ninth Circuit held that Section 523(a)(7) of the Bankruptcy Code prohibits discharging debt incurred through a state bar association's disciplinary sanction on an attorney. The Court in *In re Albert-*

Sheridan, 18-1222 (B.A.P. 9th Cir. April 11, 2019), found that state bar association sanctions fall under Section 523(a)(7)(A) and are non-dischargeable.

In *In re Albert-Sheridan*, an attorney was charged by the State Bar of California in 2015 and 2016. Ms. Albert had failed to cooperate with State Bar investigations, disobeyed court orders that ordered payment of discovery sanctions, failed to perform competent legal services, failed to render accounts of client funds, and failed to refund any unearned fees held in trust. Due to the violations she received a 30-day suspension and would also pay the court-ordered sanctions as well as the costs to the State Bar for the proceedings.

The Court's analysis relied on language in *Kelly v. Robinson*, 479 U.S. 36 (1986) where the Supreme Court held that criminal restitution paid to the state in criminal proceedings was non-dischargeable under 523(a)(7). *Kelly* established that, although the restitution was actually for the benefit of the victim, the payment was a "fine or penalty" within 523(a)(7)'s reach. The Court in *Kelly* considered the following facts: that the victim has no control over the amount of restitution or decision to award restitution; that the decision to impose restitution does not turn on the victim's injury but on the penal goals of the state and the situation of the defendant; that this is focused on rehabilitation interests of the state, rather than the victim's need for compensation. Because Ms. Albert's penalties and fines were punitive in nature, the Court did not allow discharge of these debts in bankruptcy.

Do this: Be Aware of Non-Dischargeable Debt

Be aware that if an attorney ends up in a similar situation, penalties will likely not be dischargeable. However, this does not mean that all fines from a state bar association is non-dischargeable debt.

The Bankruptcy Appellate Panel for the Ninth Circuit compared *In re Albert-Sheridan* to *Scheer v. State Bar of California*, 819 F.3d 1206 (9th Cir. 2016) where the Ninth Circuit discharged a refund of client fees ordered by the State Bar as a condition of an attorney's reinstatement of active enrollment state. This refund was ordered by an arbitrator who found that the debtor had competently performed services. The court noted that the conduct was not willful or malicious, but California law required her to return the funds. The Court of Appeals found the debt dischargeable because it was not assessed for disciplinary reasons. This ruling was narrow and hinged in the non-punitive nature of the penalty.