All in the Family, or Who Is Your Client?

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The Ethics of Joint
Bankruptcy Filings and Divorce

Eugene R. Wedoff.[1]

Introduction

At first glance, it seems that couples contemplating a divorce would be wise to file a joint bankruptcy case first.

The advantages of a prior bankruptcy filing are set out in Nolo.com—"one of the web's largest libraries of consumer-friendly legal information."[2] "Filing for bankruptcy before a divorce" the website states, "can . . . simplify the issues regarding debt and property division and lower your divorce costs as a result."[3] Several websites for private attorneys repeat this advice, largely verbatim.[4]

The Nolo website also states the advantage of filing bankruptcy jointly:

> Bankruptcy filing fees are the same for joint and individual filings. So filing a joint bankruptcy with your spouse . . . can save you a lot on court fees. Also, if you decide to hire a bankruptcy attorney, your attorney fees will likely be much lower for a joint bankruptcy than if each of you filed separately.[5]

But there is a catch. Nolo cautions that "you should let your bankruptcy attorney know about your upcoming divorce as there may be a conflict of interest for him or her to

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[1] U.S. Bankruptcy Judge, N.D.Ill. (ret.).

[2] *See* www.nolo.com, last visited March 29, 2016.

[3] *See* www.nolo.com/legal-encyclopedia/divorce-bankruptcy-which-comes-first.html, last visited March 29, 2016.

[4] *E.g,,* Bunch & Bock, Lexington Ky., http://www.bunchandbrocklaw.com/personal-bankruptcy/divorce-bankruptcy/, last visited April 2, 2016.

[5] *See* www.nolo.com/legal-encyclopedia/divorce-bankruptcy-which-comes-first.html.

represent you both."[6] That advice only hints at the potential difficulties. There are several ethical problems that joint bankruptcy representation and divorce may present to a bankruptcy attorney: beyond potential conflicts of interest, there may be difficulties with the clients' expectations of confidentiality and a potential for fraudulent transfer liability. Each of these areas are outlined below, after a list of useful resources.

1. *Relevant material*

Although there are many opinions dealing with the treatment of property and claims in the intersection of bankruptcy and divorce, the following decisions and articles appear to be the ones most directly dealing with ethical issues arising from representing divorcing spouses in a joint bankruptcy case.

• *In re Disciplinary Proceedings Against Zablocki,* 635 N.W.2d 288 (Wis. 2001). An attorney who was facing suspension of his law license represented a woman in divorce proceedings without telling her of his imminent suspension; he also filed a joint bankruptcy petition for her and her husband while the divorce was pending. In this opinion, the Wisconsin Supreme Court issued a public censure and indefinite suspension of the license.

• *In re Green,* 1989 WL 1719956 (Bankr. S.D.Ga. Sept. 8, 1989). An attorney who had filed a joint Chapter 13 case later filed a divorce case on behalf of the wife. The bankruptcy court found that actions taken by the attorney to collect child support payments from the husband whom he was representing in bankruptcy violated the automatic stay. The opinion discusses in a footnote the apparent conflict of interests in the attorney's conduct, but states that this ethical issue was not before the court.

[6] *Id.*

• C.R. “Chip” Bowles Jr., *Goldilocks, Bankruptcy and Divorce: Are the Adversarial Relationships too Much, not Enough or Just Right?* 21-JUN Am. Bankr. Inst. J. 20 (June, 2002). This article gives an excellent statement of the general rules on conflicts of interest in the bankruptcy/divorce intersection and discusses the potential for fraudulent transfer liability from property transfers in divorce decrees.

• Concurrent Session: Bankruptcy and Divorce, 111111 ABI-CLE 761 (2011), a general panel discussion that includes consideration of joint representation.

• Karmyn Wedlow & Jennifer Buchanan, Dual Representation Can Lead to a Duel with Your Clients, 55 S. Tex. L. Rev. 769 (2014), discussing ethical problems in joint representation and concluding that the economic benefits are outweighed by the ethical costs. The article outlines the potential consequences for a lawyer who fails to comply with ethical responsibilities: disqualification, monetary sanctions, and referral to disciplinary authorities. 55 S. Tex. L. Rev. at 775-77.

2. *Conflict of Interests*

a. *General rules*

The starting point for ethical representation of debtors in joint bankruptcy filings is conflicts of interest. The Model Rules of Professional Conduct, largely adopted in most states, provide a nuanced set of directives, first defining conflicts of interest and generally prohibiting representation when a conflict exists, and then providing the terms under which a conflict can be overcome by client consent.

Model Rule 1.7(a) provides the definition and prohibition. It states:

> Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

> (1) the representation of one client will be directly adverse to another client; or
>
> (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

It is important to recognize that this definition is not limited to clients whose interests are directly adverse in the matter for which the lawyer is retained, but extends to any situation in which the lawyer's ability to provide effective representation would be "materially limited" by responsibilities to another person or by personal interests of the attorney.

The potential for client consent is set out in Rule 1.7(b):

> Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
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> (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
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> (2) the representation is not prohibited by law;
>
> (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
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> (4) each affected client gives informed consent, confirmed in writing.

This potential for consent is carefully limited. First, the attorney has to reach the personal conclusion that the conflict will not prevent effective representation; second, there must be no law prohibiting it (as there is in some jurisdictions for joint representation of parties to a divorce); third, the attorney may not pursue a claim by one client against another client in the same proceeding (so, for example, in a Chapter 11 case, a creditor client of the attorney for the debtor in possession could waive the attorney's conflict of interest, but a waiver would not allow the attorney to pursue a claim objection in the bankruptcy case against that creditor); fourth, the attorney must give each client the information necessary for the client to make an informed decision about whether to consent to the representation despite the conflict; and finally, the client's consent must be in writing.

In the event that a conflict between the clients arises during joint representation, the attorney must withdraw from representing both clients, since continued representation would violate Rule 1.7(a). See Rule 1.16(a)("[A] lawyer . . . shall withdraw from the representation of a client if: (1) the representation will result in violation of the Rules of Professional Conduct . . . .") and Comment 4 to Rule 1.7 ("If a conflict arises after representation has been undertaken, the lawyer ordinarily must withdraw from the representation . . . ."). The attorney could continue representing one of the spouses while the other obtained a new attorney only with informed consent, as provided in Rule 1.9(a) ("A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same . . . matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.").

b. *Divorce planned at the time of the bankruptcy filing*

The money-saving approach of a joint bankruptcy by a couple planning to divorce has the difficulty that the divorcing couple often disagree with one another, sometimes passionately. For example, in *In re Dube*, 2013 WL 1743849 (Bankr. C,D,Cal. April 23, 2013), a divorcing couple engaged in 13 years of litigation involving an individual Chapter 11 case filed by one of them. Even if spouses appear amicable when they seek bankruptcy advice in contemplation of a divorce, a joint bankruptcy carries the risk of later conflicts between the two clients. Before filing a joint case—whether or not a divorce is contemplated—an attorney should take the following steps:

- *Assure that there are no bankruptcy issues in dispute between the spouses.* If there is any potential for a dispute between the spouses over a bankruptcy matter—such as an inter-spousal claim, the response to a particular creditor's claim, or ownership of property—a joint filing would be an ethical violation, because the representation of each party would be limited by the attorney's responsibilities to the other party, and the conflict could not be eliminated by consent, since any action that the attorney took would be against the other client's interest.
- *Give full disclosure to both clients regarding the potential for conflicts that might arise in the future and require the attorney's withdrawal.* This disclosure would reduce client resentment in the event of withdrawal, but a separate disclosure would have to be made to obtain any informed consent to continued representation of either party.
- *Do not represent either of the spouses in the subsequent divorce.* Although it might theoretically be possible to get informed consent from a client in the bankruptcy case to conflicting representation of one of them in the divorce case (because that would not be "in the same litigation" in which the attorney represented both clients), it would be extraordinarily difficult to be a client's advocate in bankruptcy and simultaneously the client's opponent in the divorce. This situation—albeit without an attempt to obtain informed consent—led to a suggestion of unethical conduct in *Green,* 1989 WL 1719956 at *6 n.1; and the imposition of ethical sanctions in *Zablocki,* 635 N.W.2d at 291.

- *Do not file a joint Chapter 13 case if divorce is anticipated.* Chapter 13 would not eliminate the need to address the allocation of claims against the spouses in the divorce case because there would be no prompt discharge of those claims. And in Chapter 13, disagreements could arise not only about property interests and claims, but also about allocation of payments to the trustee and the need for—and terms of—any plan modification. If one of the spouses wishes to retain jointly-owned property that is collateral for a loan, Chapter 13 might be necessary for that spouse, but the other would likely be best served by a separate Chapter 7 filing.

c. *Marital dispute first arising after a joint filing*

Just as a joint bankruptcy can be filed on behalf of spouses anticipating a divorce, a joint bankruptcy can be maintained on behalf of spouses who first decided to divorce while their bankruptcy case is pending. Unexpected marital discord is most likely to occur in Chapter 13 cases, because of the longer time before these cases conclude. In such cases, the attorney should have informed the spouses at the outset of the case that any disputes between them over bankruptcy matters would require the attorney to withdraw from their representation. If bankruptcy-affecting disputes do arise—likely over the plan modification and allocation of trustee payments—the attorney would have to withdraw and advise the clients to retain separate bankruptcy counsel unless informed consent is given—which is unlikely if the clients are in a contentious dispute.

3. *Confidentiality*

a. *General rules*

Rule 1.6(a) of the Model Rules of Professional Responsibility sets out the general prohibition against attorney disclosure of client confidences: "A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, [or] the disclosure is impliedly authorized in order to carry out the representation . . . ."

Rule 1.6(b) sets out exceptions to the prohibition that would not generally apply in joint bankruptcy representation, but the two exceptions set out in Rule 1.6(a) itself do apply. First, the exception for "impliedly authorized" disclosure would allow the attorney to disclose to one of the spouses whatever relevant information the attorney received from the other spouse. *See Securities Investor Protection Corp. v. R.D. Kushnir & Co.,* 246 B.R. 582, 588 (Bankr. N.D.Ill. 2000) ("Under the 'joint defense doctrine' if the same lawyer jointly represents two or more clients with respect to the same matter, those clients have no reasonable expectation that their communications to the lawyer with respect to the joint matter will be kept secret from each other."). Second, the exception for "informed consent" would allow either spouse to require the attorney to disclose information that either spouse conveyed to the attorney in confidence. *See* Teresa Stanton Collett, *The Promise and Peril of Multiple Representation*, 16 Rev. Litig. 567, 579 (1997) ("[A]ny joint client can require the attorney to testify about such disclosures when a dispute arises between the joint clients.").

Rule 1.9(c) imposes a confidentiality limitation on continued representation of one spouse after the attorney withdraws from representation of the other: "A lawyer who has formerly represented a client in a matter . . . shall not thereafter . . . reveal information relating to the representation except as these Rules would permit or require with respect to a client." See Comment 7 to Rule 1.9 ("Independent of the question of disqualification of a firm, a lawyer changing professional association has a continuing duty to preserve confidentiality of information about a client formerly represented.")

b. *Effect on joint bankruptcy representation*

A major concern for an attorney representing spouses in a joint bankruptcy is the potential for their not realizing the limits on confidentiality that the law has established. It is critical for the attorney to advise the clients at the outset of the representation that no statements they make to the attorney in connection with the bankruptcy case can be withheld from their spouse and that either of them can require the attorney to disclose their confidential statements in any controversy that may arise between them in the future.

4. *Fraudulent transfer liability*

One potential benefit of a divorce in connection with bankruptcy is that it typically divides the property of the spouses between them, and, in this way property that was subject to the claims against only one of the spouse can be freed from those claims by being awarded to the other spouse. Even if the divorce court order makes a substantially unequal division of the marital property, the division may be seen as supported by reasonably equivalent value to both spouses, and so immune from challenge as a constructively fraudulent transfer under § 548(a)(1)(B). *See, e.g., In re Kimmell,* 480 B.R. 876, 889-90 (Bankr.N.D.Ill.2012). However, courts are sensitive to the possibility that spouses may use the divorce process to facilitate an actual intent to defraud creditors. The authorities are collected in *Shaudt v. United States,* 2013 WL 951138, at *5 (N.D. Ill. March 11, 2013):

> Courts have recognized that divorce can be used to lend an air of legitimacy to an otherwise fraudulent transfer. *See, e.g., In re Chevrie,* 2001 WL 120132, at *10 (Bankr.N.D.Ill. Feb.13, 2001) (finding the transfer of a marital home pursuant to a divorce settlement fraudulent because the transfer was made

> for the purpose of placing the home outside of the reach of the IRS). Such sham divorces often share certain "badges of fraud," including: (1) a quickly agreed upon property division; (2) the completion of the divorce proceeding on a "fast-track;" (3) the fact that only one of the spouses is represented by counsel in the divorce proceeding; (4) the fact that the spouses continue to live together after the divorce decree in the very house that was transferred; (5) the fact that the transferor spouse continues to pay the mortgage, taxes, and other costs on the transferred house; and (6) the inequitable distribution of debts and assets in the divorce. *Id.; see also In re Pilcher,* No. 05–8044, 2008 WL 2682858, at *4 (Bankr. C.D.Ill. Jun.25, 2008); *In re Hill,* 342 B.R. 183, 199–200 (Bankr.D.N.J.2006); *In re Zamudio,* No. 04 A 02922, 2005 WL 2035969, at *9–10 (Bankr. N.D.Ill. Aug.23, 2005); *In re Rodgers,* 315 B.R. 522, 531 (Bankr. N.D. 2004); *In re Boba,* 280 B.R. 430, 434–35 (Bankr. N.D.Ill. 2002); *In re Dunham,* No. 98–1466–MWV, 99–1054–MWV, 2000 WL 33679421, at *4 (Bankr. D.N.H. 2000).

On the other hand, it has been held that a regularly conducted divorce proceeding, with no indication of collusion, is entitled to a presumption of validity. *Batlan v. Bledsoe (In re Bledsoe),* 569 F.3d 1106, 1112 (9th Cir. 2009) ("[A] state court's dissolution judgment, following a regularly conducted contested proceeding, conclusively establishes 'reasonably equivalent value' for the purpose of § 548, in the absence of actual fraud."); *Ingalls v. Erlewine (In re Erlewine),* 349 F.3d 205, 212 (5th Cir.2003) ("[W]e should hesitate before we impute to Congress an intent to upset the finality of judgments in an area as central to state law as divorce decrees.").

This state of the law makes it important for attorneys representing a spouse in a divorce case to avoid uncontested transfers of property obviously subject to enforcement of judgment. If spouses seek bankruptcy representation after such a transfer, bankruptcy counsel should warn of the potential liability for a fraudulent transfer.

Though not directly involving a divorce proceeding, *In re Prince,* 40 F.3d 356 (11th Cir. 1994), provides an example of the difficulty that bankruptcy counsel may face in this situation. In *Prince,* a Chapter 11 debtor had made a large transfer to his wife, and the law firm for the debtor had earlier represented both the husband and wife in estate planning matters. The court held that because the wife was potentially a defendant in a fraudulent transfer action, and because the attorney had previously represented the debtor's wife, the firm had a conflict of interest in representing the husband in his Chapter 11 case, and on that basis all fees for the bankruptcy representation were denied. "By representing Prince in his bankruptcy proceedings, [the firm] deprived Prince of a conflict-free, impartial, independent evaluation of the potential claims of and against his estate." *Id.* at 360. This decision is questionable; another lawyer would have faced the same difficulty, since the debtor had a personal interest in allowing his wife to keep the transferred property that would have interfered with his duty to the estate. A key to avoiding denial of fees in this situation is full disclosure of all transfers made by one spouse to the other in the bankruptcy schedules and in any application to be retained as counsel.

So They Filed Bankruptcy: What about the Lawsuit !!

Bankruptcy Issues Related to Consumer Debtor Litigation

I. Surviving Bankruptcy: Basic Concepts

A. Property of Estate 11 U.S.C. § 541; 11 U.S.C. § 1115(Individual Chapter 11 Debtor Post petition income is property of the Estate)

Specifically included in the definition of property under the Bankruptcy Code are:

1. Filed lawsuits. *See, e.g. Stephenson v. Malloy*, 700 F.3d 265 (6th Cir. 2012) (Pre-petition lawsuit was property of the estate).
2. Claims from incidents that occurred pre-petition is property of the Bankruptcy estate. *See, e.g., Marable v. Marion Military Institute*, 595 Fed. Appx. 921 (11th Cir. 2014) (lawsuit not filed prior to bankruptcy related to employment discrimination which occurred pre-petition was property of the estate).

II. So the Debtor Filed Bankruptcy. What Happens to Claim/Lawsuit?

A. If the lawsuit or claim is not listed in bankruptcy schedules, if you are the Trustee of Debtor's counsel you must get the lawsuit or claim listed as soon as possible. Failure to initially list claims or timely add claims (*i.e.,* before the defendant moves to purchase or dismiss the claim), will likely result in the debtor (or the Bankruptcy Estate) being judicially estopped from pursuing the claim. *See White v. Wyndham Vacation Ownership, Inc.*, 617 F.3d 472 (6th Cir. 2010) (Debtor judicially estopped from bringing harassment lawsuit when she omitted claim from Chapter 13 case); *Lewis v. Weyerhaeuser*, 141 Fed. Appx. 420 (6th Cir. 2005) (Debtor filed chapter 13, but did not list EEOC discrimination claim. Debtor was estopped from pursuing the claim post-petition.) *See also Sinkfied v. State Farm Insurance*, 580 Fed. Appx. 323 (6th Cir. 2014) (Debtor filed chapter 7 case and listed $27,000 in personal property post-petition, her house burned down and she claimed a loss of $170,000. Held: Debtor's insurance policy was voided for fraud.).

However, if debtor (or debtor's counsel) attempts to disclose the claims to the Trustee prior to either the closing of the bankruptcy case or when the defendant moves for dismissal, the trustee or debtor may be able to pursue the claim for the benefit of the debtor's creditors.

See Eubanks v. CBSK Financial Group, Inc., 385 F.3d 894 (6th Cir. 2004) (Debtor who constantly, but <u>unsuccessfully</u> attempted to disclose lender liability claim not listed in schedules did not act in bad faith and, therefore, trustee could pursue claim on behalf of the estate).

B. If the claim lawsuit is listed, we are in the clear, right?

1. Actually, you still need to see if you can employ the pre-petition counsel. First, you must determine what chapter the debtor filed under to determine who is the Actual Client?

   a. Chapter 7

   If the debtor filed a chapter 7 case, then the trustee, on behalf of the bankruptcy estates, owns and controls the claim, unless it is totally exempt from the creditor's claims (an issue that will be resolved by the Bankruptcy Court). *See, e.g., In re Cottrell*, 876 F.2d 540 (6th Cir. 1989) (Bankruptcy estate is owners of personal injury suit of debtor and had the authority to replace pre-petition counsel for debtors).

   If it is a chapter 7 case, the Trustee and pre-petition Debtor's counsel must determine whether the pre-petition counsel can and should represent the estate. *See Lennear, et al. v. Diamond Pet Food Processors*, 2015 WL 7571560 (E.D. Cal. 2015) (Trustee could retain per-petition law firm which represented debtor in discrimination suit). *See also* Ethical Attorney-Client Privilege and Retention Issues.

   b. Chapter 13

   Here, as a general rule courts have held that the debtors will be able to control suit subject to Bankruptcy Court's oversight, although pre-petition counsel should be retained under 11 U.S.C. § 327(e) to represent the state or will be denied all fees. *See, e.g., In re Alexander*, 469 B.R. 684 (Bankr. W.D. Ky. 2012) (failure to be timely retained will result in a denial of all fees and expenses).

   c. Chapter 11 or Chapter 12

   In these cases, unless a trustee is appointed, the debtor will be able to pursue the litigation subject to Bankruptcy Court's control and as in chapter 13 cases, you must make sure you are retained by the debtor and have your employment approved by the Court.

Who Controls a Debtor's attorney client Privileges

A problem which frequently arises in bankruptcy cases concerns the control of an individual's attorney client privilege. The issue of who holds a Chapter 11 debtor's attorney/client privilege has been often litigated[1] and has been largely resolved in the area of business entities by the Supreme Court's decision in Commodity Futures Trading Commission v. Weintraub[2] . However, while the Weintraub Court held that the debtor in possession or trustee held a Chapter 11 corporate debtors' attorney/client privilege[3] and could waive it even over the objection of the debtors' pre-bankruptcy management, the Weintraub Court refused to extend its reasoning to individual debtors' attorney/client privilege ruling:

> [O]ur holding today **has no bearing on the problem of individual bankruptcy, which we have no reason to address in this case**. As we have stated, a corporation, as an inanimate entity, must act through agents. When the corporation is solvent, the agent that controls the corporate attorney-client privilege is the corporation's management. Under our holding today, the power passes to the trustee because the trustee's functions are more closely analogous to those of management outside of bankruptcy than are the functions of the debtor's directors. An individual, in contrast, can act for himself; there is no "management" that controls a solvent individual's attorney-client privilege. If control over that privilege passes to a trustee, it must be under some theory different from the one that we embrace in this case.[**emphasis added**][4]

Lower courts have taken three general positions[5] with regard to who holds an individual Chapter 11 debtor's attorney/client privilege. One line of mainly older cases has held that an individual Chapter 11 debtor's attorney/client privilege (for both pre and post-bankruptcy periods) remains with the individual debtor and does not pass to the bankruptcy estate or a subsequently appointed trustee[6]. These courts have generally held that due to the greater privacy concerns that arise when an individual holds an attorney/client privilege, there is no justification for the transfer of attorney/client privilege to either the bankruptcy estate or the individual debtor's trustee[7].

Another group of cases, led by In re Williams[8], has held that the right to who holds the attorney/client privilege does not change merely because a debtor is an

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1 See generally In re O.P.M. Leasing Services, Inc., 670 F.2d 383 (2d Cir. 1982); Citibank N.A. v. Andros, 666 F.2d 1192 (8th Cir. 1981).

2 471 U.S. 343 (1985).

3 Id. at 354.

4 Id. at 356-357.

5 In re Bame, 251 B.R. 367, 377-378 (Bkrtcy. D.Minn. 2000).

6 See In re Hunt, 153 B.R. 445 (Bkrtcy. N.D.Tx. 1992) (Trustee under confirmed plan not entitled to waive the attorney/client privilege); In re Silvio De Lindegg Ocean Dev. Of America, Inc., 27 B.R. 28 (Bankr. S.D. Fla. 1982) (same)

7 In re Hunt, 153 B.R. at 454. But see In re Fairbanks, 135 B.R. 717 (Bkrtcy. D.N.H. 1991) (Finding "other theory" to hold that trustee controlled chapter 11 debtor's attorney/client privilege).

8 152 B.R. 123 (Bkrtcy N.D.Tx. 1992); See also In re Smith, 24 B.R. 3 (Bkrtcy. S.D. Fla. 1982) (Pre Weintraub)

individual and not a business entity. These cases have generally held that an individual debtor in possession must exercise its attorney/client privilege in a manner consistent with its fiduciary duty to creditors and that includes the transfer or waiver of its attorney/client privilege for the benefit of the estate[9]. These courts have found that the individual Chapter 11 Debtor's attorney client privilege passes to his or her bankruptcy estate and does not remain in the hands of the individual[10].

The final[11] and largest line of authority concerning individual Chapter 11 debtor's attorney/client privilege has stated that courts must determine who holds the attorney/client privilege on a case by case basis by balancing the policies underlying the attorney/client privilege and the potential harm of disclosure to the individual against the trustee's duty to maximize the value of the estate[12].

Under this line of reasoning, courts have generally determined that an individual debtor has no attorney/client privilege for any post-petition discussions the individual has with the estate counsel, holding that the estate counsel generally cannot give individuals legal advice, in their capacity as an individual, while acting as the estate's counsel. These courts have also held that pre-bankruptcy discussions with attorneys are subject to an individual attorney/client privilege[13].

Under all of these lines of cases, the estate's counsel should carefully advise the individual as to who they represent in the chapter 11 (the bankruptcy estate generally)and the issues that may arise related to the individual attorney/client privilege (or lack thereof) when filing a Chapter 11 case.

I. General Overview of Attorney/Client Privileges In Joint Client Situations

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9 In re Williams, 152 B.R. at 128 (noting that under Toibbv Radloff, 501 U.S. 157 (1991) (Individual Debtor had fiduciary responsibilities of a corporate debtor in possession).

10 See e.g. In re Wittmer, 2011 Bankr. Lexis 4727 (Bankr. N.D. Ohio 2011) (trustee of an individual Chapter 7 debtor investigating legal malpractice claim against could waive the Privileges attorney could not raise Privilege claims to thwart discovery against them); In re Tarkington, 2010 Bankr. Lexis 1208 (Bankr. E.D. N.C. 2010) (2004 exam of individual Chapter 11 debtor's counsel allowed to go forward to determine assets in corporation owned by debtor)

11 There is also a group of cases involving the waiver of an individual debtor's attorney/client privilege in the context of legal malpractice claims against a debtor's attorney. In these cases bankruptcy courts have generally held that the trustee holds and has the right to waive the attorney/client privilege for the purpose of investigating the malpractice action. See In re Bazemore, 216 B.R. 1020 (Bkrtcy. S.D. Ga. 1998), In re Tomarolo, 205 B.R. 10 (Bkrtcy. D. Mass. 1997) But see McClarty v. Gudenau, 166 B.R. 101 (E.D. Mich. 1994) (Individual Chapter 7 debtor holds attorney/client privilege as to file involved in malpractice action).

12 See generally In re Foster, 188 F.3d 1259 (10th Cir. 1999); In re Benum, 339 B.R. 115 (Bkrtcy. D.N.J. 2006); In re Eddy, 304 B.R. 591 (Bkrtcy. D. Mass. 2004); In re Miller, 247 B.R. 704 (Bkrtcy. N.D. Ohio, 2000).

13 See In re Bame, 251 B.R. 367, 375-376 (Setting forth a 5 part test to see if individual received individual legal advice from estate counsel [which would be subject to the individual's attorney client privilege] or advice as debtor in possession [which would not be subject to the individual attorney client privilege, but to the bankruptcy estate's privilege]).

Initially, it is well settled that the trustee or DIP of a corporate Chapter 11 debtor holds the attorney/client privilege of that legal entity. See Commodity Futures Trading Commission v. Weintraub, 471 U.S. 343 (1985) (trustee succeeds to attorney/client privilege of debtor corporations). The Sixth Circuit, in Reed v. Baxter, 965 F.2d 126 (6th Cir. 1992) states that:

> The question of whether the attorney/client privilege applies is a mixed question of law and fact, subject to de novo review. See In re Grand Jury Proceedings October 12, 1995, 78 F.3d 251, 253-54 (6th Cir.1996). Questions of privilege are to be determined by federal common law in federal question cases. Fed.R.Evid. 501. The elements of the attorney/client privilege are as follows: (1) Where legal advice of any kind is sought (2) from a professional legal adviser in his capacity as such, (3) the communications relating to that purpose, (4) made in confidence (5) by the client, (6) are at his instance permanently protected (7) from disclosure by himself or by the legal adviser, (8) unless the protection is waived. Fausek v. White, 965 F.2d 126, 129 (6th Cir.1992) (citing United States v. Goldfarb, 328 F.2d 280, 281 (6th Cir.1964)).

The privilege is based on two related principles. The first is that loyalty forms an intrinsic part of the relationship between a lawyer and client in our adversary system. This loyalty is offended if the lawyer is subject to routine examination regarding the client's confidential disclosures. Kenneth S. Brown, et al., McCormick on Evidence § 87, at 205-06 (3rd ed.1984). The second principle is that the privilege encourages clients to make full disclosure to their lawyers. A fully informed lawyer can more effectively serve his client and promote the administration of justice. Id. § 87, at 205; id. § 89, at 212.

The privilege serves these purposes, but it comes with substantial costs. The privilege excludes relevant evidence and stands "in derogation of the search for the truth." United States v. Nixon, 418 U.S. 683, 710, 94 S.Ct. 3090, 3108, 41 L.Ed.2d 1039 (1974). When an organization, such as a corporation, is the client the costs imposed by application of the privilege increase. Given the number of employees who may have information relevant to litigation by or against a corporation, administration of the privilege by the courts proves difficult. More significantly, "[w]here corporations are involved, with their large number of agents, masses of documents, and frequent dealings with lawyers, the zone of silence grows large." David Simon, The Attorney/Client Privilege as Applied to Corporations, 65 Yale L.J. 953, 955 (1956); see also 24 Charles Alan Wright & Kenneth W. Graham, Jr., Federal Practice and Procedure: Evidence § 5476, at 189 (1986); id. § 5476, at 29 (1997 Suppl) (noting that corporations may use the privilege to prevent the disclosure of information useful to adversaries simply by funneling it through lawyers).

Assuming that a valid joint defense agreement exists between Law firm X's clients (Subsidiary and Individual A) and Lawfirm Y's clients, (Individuals A, B, Subsidiary and

Parent Company) and that all privileged discussions were made between the law firm and each client and no other clients were present at the discussions between the law firm and the client.

A dual or joint representation, absent an agreement to establish a "joint defense" between clients, may render any attorney/client privilege inapplicable because non-clients were parties to the privileged communications. See Matter of Bevill Breslder & Schulman Asset Management Corporation, 865 F.2d 120, 124-126 (3rd Cir. 1986); In re Indiantown Realty Partners, Lmt. Partnership, 270 B.R. 532 (Bankr. S.D. Fla. 532, 539-540) (Bankr. S.D. Fla. 2001). See also In re Miracle Enterprises, Inc., 40 B.R. 503 (Bankr. D. R.I. 1984) (no attorney/client privilege with respect to communications between Defendant bank and attorney, where attorney served as secretary of Debtor and counsel to bank); U.S. v. Moss, 9 F.3d 543 (6th Cir. 1993). ("Generally, the attorney/client privilege extends to "(c)onfidential disclosures by a client to an attorney made in order to obtain legal assistance."); Haines v. Liggett Group, Inc., 975 F.2d 81, 94 (3rd Cir. 1992) (quoting, Fisher v. United States, 425 U.S. 391, 403, 96 S.Ct. 1569, 1577, 48 L.Ed.2d 39 (1976)). A joint defense extension of the attorney/client privilege has been applied to confidential communications shared between co-defendants which are "part of an on-going and joint effort to set up a common defense strategy." Haines, 975 F.2d at 94 (quoting Eisenberg v. Gagnon, 766 F.2d 770, 787 (3rd Cir.), cert. denied, 474 U.S. 946, 106 S.Ct. 342, 88 L.Ed.2d 290 (1985). The burden to establish the applicability of the privilege is upon the defendants. Haines, 975 F.2d at 94.

Even assuming that a joint defense privilege exists, however, it has been universally held that communications that are otherwise privileged under the common interest or joint defense doctrine are not privileged in subsequent litigation between the parties to the joint defense agreement. See Simpson v. Motorists Mutual Insurance Company, 494 F.2d 850 (7th Cir. 1974) (recognizing the existence of the doctrine in a diversity case governed by Ohio law); Duncan v. Duncan, 2001 WL 1837384 (Va. Cir. Ct. July 16, 2001) (Not reported in S.E.2d) ("The clear majority of reviewing courts has held that the attorney/client privilege does not preclude an attorney who originally represented both parties in a prior matter from disclosing information in a subsequent action between the parties."). See also Abbott Laboratories v. Alpha Therapeutic Corp., 200 F.R.D. 401 (N.D. Ill. 2001); Securities Investor Protection Corporation v. Stratton Oakmont, Inc., 213 B.R. 433 (Bankr. S.D. N.Y. 1997); In re Megan-Racine Associates, Inc., 189 B.R. 562 (Bankr. N.D. N.Y 1995). Therefore, Parent Company may be able to obtain all otherwise privileged communications of all other parties under a joint defense agreement.

II. Specific Issues

Question A: Can a Parent Company DIP or trustee waive Subsidiary's or the Individual A's privilege?

The Parent Company DIP or trustee cannot waive, under any circumstances, the attorney/client privilege between either Lawfirm X or Lawfirm Y and Individual A as the Parent Company bankruptcy estate has no interest in or control over Individual A's attorney/client privilege. While some courts have allowed trustees to waive the attorney/client privilege of individual debtors, see, generally, In re Eddy, 304 B.R. 591 (Bkrtcy. D. Mass. 2004); In re Williams, 152 B.R. 123 (Bkrtcy. N.D. Tx. 1992), no court has ever permitted a corporation to waive its individual owner's attorney/client privilege. See generally In re Bakalis, 199 B.R. 443, 449 (Bkrtcy. E.D. N.Y 1996) (trustee of Chapter 7 estate of majority owner of a corporation could not compel corporation to waive its attorney/client privilege).

If it is established that Individual A was given advice by either Lawfirm X or Lawfirm Y, as an officer or employee of Subsidiary, however, then Individual A's ability to claim, as an individual, an attorney/client privilege will be greatly compromised. See In re National Trade Corporation, 76 B.R. 646 (N.D. Ill. 1985); In re Southern Air Transport, Inc., 225 B.R. 706 (Bkrtcy. S.D. Ohio 2000); In re Fidelity Guarantee Mortgage Corp., 150 B.R. 854 (Bkrtcy. D. Mass. 1993); In re Cumberland Inv. Corp., 120 B.R. 627 (Bkrtcy. D. R.I. 1990).

As to the attorney/client privilege of Subsidiary, Parent Company as the owner of Subsidiary, may not directly waive the Subsidiary's attorney/client privilege. As noted in Bakalis, the owner of the stock in a corporation may not waive the attorney/client privilege for that corporation absent certain specific showings of good cause, which will permit the owner of the corporation to obtain the privileged documents. Bakalis, 199 B.R. at 449; see also Fausek v. White, 965 F.2d 126, 130-131 (6th Cir. 1992).

A Parent Company DIP or trustee could indirectly cause Subsidiary to waive its own attorney/client privilege if they either gain control of the individuals who were actually running the Subsidiary bankruptcy or were able to use their corporation ownership to cause a change in control of the management of Subsidiary in its Chapter 11 case. See In re Lionel Corporation, 30 B.R. 327 (Bkrtcy S.D. N.Y. 1983) (holding that "shareholders of Chapter 11 Debtors generally retain their state controlled rights to control a Chapter 11 Corporation within the requirements of the Bankruptcy Code"). However, the change of management of a Chapter 11 could be subject to Bankruptcy Court approval, see Matter of Gaslight Club, Inc., 782 F.2d 767 (7th Cir. 1986); Matter of Lifeguard Industries, Inc., 37 B.R. 3 (Bkrtcy. S.D. Ohio 1983). However, even with these limitations, a Parent Company DIP or trustee, by meeting the proper legal standards, could cause Subsidiary to waive its attorney/client privilege.

Question B: Can Subsidiary's waive the attorney/client privilege of Individual A?

As discussed above, Subsidiary may not waive the individual attorney/client privilege between Individual A and either Lawfirm X or Lawfirm Y because Subsidiary does not have any interest in or control over Individual A's attorney/client privilege. See, generally, In re Bevill, Bresler and Schulman, 805 F.2d 120, 123 (3rd Cir. 1986) (corporate officer may assert a personal attorney/client privilege for communications made to his or her own counsel concerning personal liability unrelated to the corporation or his role as a corporate officer).

Subsidiary can waive its own attorney/client privilege as to any communications Lawfirm X or Lawfirm Y had with Individual A, if those communications were made in the course of Lawfirm X's or Lawfirm Y's representation of Subsidiary, and not as part of their representation of Individual A. See In re National Trade Corporation, 76 B.R. at 647 (corporate officers barred from asserting privilege for communications made in their corporate capacity to corporate counsel); In re Southern Air Transport Inc., 255 B.R. at 710-712 (corporate officers cannot assert attorney/client privilege to prevent debtor corporation from obtaining testimony from its own attorney); In re Fidelity Guarantee Mortgage Corp., 150 B.R. at 867-869 (corporate waiver of corporate debtor's attorney/client privilege extends to words and actions of corporate debtor's officers and directors).

Question C: Can a third party force Subsidiary to waive its own attorney/client privilege or the attorney/client privilege of Individual A?

Initially, it is clear that a creditor or other third party cannot force Subsidiary to waive Individual A's attorney client privilege, as Subsidiary itself may not waive the attorney/client privilege between Lawfirm X, Lawfirm Y and Individual A because Subsidiary has no interest in or control over Individual A's attorney/client privilege.

A creditor or other party in interest could ultimately require Subsidiary to waive its own attorney/client privilege, however, either by obtaining the appointment of a trustee in the Subsidiary bankruptcy case, see Commodity Futures Trading Commission v. Weintraub, 471 U.S. 343 (1985), or by filing a motion to force the Debtor to waive the attorney/client privilege. See, generally, In re Gibson Group Inc., 66 F.3d 1436 (6th Cir. 1995) (creditor granted standing to pursue preference suit where debtor unjustifiably refused to bring preference action). While there is no established case law permitting a third party to force a debtor to waive its attorney/client privilege, under the authority of the Gibson Group case, such a motion would have merit in the circuits which have adopted this position.

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material declaration in a bankruptcy case. *United States v. Gellene*, 182 F.3d 578 (7th Cir. 1999).

IV. PRIOR AND MULTIPLE REPRESENTATIONS

A. **General**.

In various instances, especially cases involving closely held debtors, the professional seeking to be employed or compensated has represented not only the debtor, but also certain other parties connected with the debtor. At what point the representation of the debtor and other parties becomes a violation of the adverse interest standard is extremely difficult to determine. What is not difficult is the admonition that the attorney must be extremely diligent in investigating any connections that it has with the debtor and any other parties in interest. As mentioned previously, these parties in interest include relatives of the debtor, officers, directors, shareholders, or other equity security holders of the debtor, affiliated corporations with the debtor, partners of the debtor and, of course, creditors of the debtor.

Failure to disclose these relationships is, in and of itself, grounds for denial of compensation or employment without ever reaching the substantive issue of whether an adverse interest exists. Therefore, at the very minimum, the Bankruptcy Rule 2014 statement by the professional must disclose all connections with the debtor. As will be seen, most courts take a very practical approach to the types of conflicts which may arise due to multiple or dual representation.

B. **Representation of Relatives of the Debtor**.

Prior representation of a relative of the debtor should also be closely examined. *See, e.g., In re Siesta Sands Dev. Corp.*, 84 B.R. 789 (Bankr. M.D. Fla. 1988), *aff'd in part and rev'd in part, remanded,* 118 B.R. 108 (M.D. Fla. 1990) (The prior representation of a cousin of the debtor corporation's principal was found not to be a conflict of interest); *In re Career Concepts,* *Inc.*, 76 B.R. 830 (Bankr. D. Utah 1983) (A father and brother to an officer of the debtor were not disinterested and consequently could not be employed as attorneys for the debtor).

C. **Representation of Officers, Directors or Shareholders of the Debtor**.

There is a significant body of case law considering the issue of the impact of an attorney's representation of the debtor and also an officer, director or shareholder of the debtor, including the following:

1. In *In re B.H.&P. Inc., 949 F.2d 1300* (3rd Cir. 1991), it was held that a law firm representing the trustee in the related bankruptcy cases of a corporation and its principals should be removed as counsel in the cases for the principals because the multiple representations caused an actual conflict of interest.

2. In *In re Humble Place Joint Venture*, 936 F.2d 814 (5th Cir. 1991), the court found an actual conflict of interest in debtor's counsel's representation of both the debtor, a real estate partnership, and its investors, guarantors of the partnership debt.

3. In *In re Consolidated Bancshares, Inc.*, 785 F.2d 1249 (5th Cir. 1986), remanded the case to the bankruptcy court to determine whether debtor's counsel's simultaneous representation of former officers and directors of the debtor created a legally disabling conflict of interest.

4. In *In re Freedom Solar Center, Inc.*, 776 F.2d 14 (1st Cir. 1985), the court stated that generally the representation of both the debtor and the debtor's sole shareholder may not involve adverse interests, "but when the sole shareholder desires to purchase estate assets and when the sole shareholder may be the recipient of preferential transfers, adverse interests do result."

5. In *In re Granite Sheet Metal Works, Inc.*, 159 B.R. 840 (Bankr. S.D. Ill. 1993), counsel for a Chapter 7 debtor was denied compensation due to a failure to disclose that it had represented both the debtor and its principal in a pre-petition stock redemption transaction pursuant to which the debtor transferred at least $820,000.00 of corporate assets to insiders.

6. Counsel for a Chapter 11 debtor was denied compensation due to simultaneous representation of the debtor and the purchaser of the debtor's assets, in addition to representation of the officer accused of "looting" the debtor's assets. *In re Chestnut Hill Mortgage Corp.*, 158 B.R. 547 (Bankr. D.C. Mass. 1993), *aff'd sub nom, Rome v. Braunstein*, 19 F.3d 54 (1st Cir. 1994).

7. The court denied the application for compensation by counsel for a Chapter 7 debtor on the grounds that counsel for the corporate debtor also represented the debtor's principal shareholder, concluding that the purpose of the bankruptcy was to benefit the shareholder rather than the estate. *In re Westwood Homes, Inc.*, 157 B.R. 182 (Bankr. D. Me. 1993).

8. A law firm could not represent a corporate debtor as well as the debtor's majority shareholder which owed the debtor a large debt, due to the entangled financial dealings of the debtor and its shareholder. *In re Black Hills Greyhound Racing Ass'n*, 154 B.R. 285 (Bankr. D.S.D. 1993).

9. In *In re United Utensils Corp.*, 141 B.R. 306 (Bankr. W.D. Pa. 1992), the Court distinguished between rendering legal advice to an officer or shareholder of a corporate debtor on matters of his individual interest, which could constitute a conflict of interest, and providing legal advice concerning those individuals' official duties or the general affairs of the corporation, which poses no conflict.

10. A law firm was not disqualified from representing both a corporate debtor and its sole shareholder because there was no debtor-creditor relationship between the two entities and creditors of both were substantially the same. *In re Professional Dev. Corp.*, 140 B.R. 467 (Bankr. W.D. Tenn. 1992).

11. In *In re Apex Oil Co.*, 128 B.R. 671 (Bankr. E.D. Mo. 1991), a firm which voluntarily withdrew its representation was denied compensation during the time period in which it failed to disclose its insider relationships with the debtor, including that partners had been corporate officers and directors of debtor entities, partners owned stock in the debtor, and the firm represented partners of the debtor.

12. In *In re U.S. Jet, Inc.*, 127 B.R. 11 (Bankr. E.D. Va. 1991), the court denied fees to a professional who simultaneously represented the debtor and its shareholder in the negotiations leading to the sale of corporate assets, where the proceeds from the initial payment went to the secured creditor whose debt the shareholder had guaranteed.

13. An attorney's use of a corporate debtor's assets to secure a release of liability of a corporate shareholder was against the interests of the corporation and therefore prohibited compensation of the attorney. Some fees were ultimately allowed because of the value of the services provided. *In re Golden Recipe Chicken, Inc.*, 109 B.R. 692 (Bankr. W.D. Pa. 1990).

14. An attorney for the debtor who also represented the debtor's controlling officer was denied fees for failing to disclose this information, which was relevant to a determination of the attorney's disinterestedness. *In re Churchfield Management and Inv. Corp.*, 100 B.R. 389 (Bankr. N.D. Ill. 1989).

15. In a case where the debtor's attorneys rendered services solely for the benefit of the debtor's chief executive officer and were paid for by that officer, the court found a conflict of interest and the attorneys could not be compensated for their services. *In re Global International Airways Corp.*, 82 B.R. 520 (Bankr. W.D. Mo. 1988).

16. In *In re Kendavis Industries International, Inc.*, 91 B.R. 742 (Bankr. N.D. Tex. 1988), the court examined the conduct of the debtor's counsel and determined that the ultimate beneficiaries of counsel's services and the reorganization plan were the debtor's shareholders. Therefore, counsel had a fatal conflict of interest during its representation of the debtor. The factors considered by the court were as follows:

ii. The proposed consolidation of debtors resulted in a significantly larger dividend for creditors of a particular debtor, including a non-debtor entity with a $10.4 million disputed claim of which the same shareholder had an 87% ownership interest.

iii. Twenty year partial payment to unsecured creditors had the effect of preserving any "upside" growth in the debtor companies for the shareholders only.

iv. Debtors counsel's opposition to the Committee's plan benefitted only the shareholders.

v. Debtor's counsel proposed to the court to sell a debtor corporation providing that over $4 million in non-competition compensation would be paid to shareholders, notwithstanding that the original agreement stated that the debtor's estate would receive the money.

vi. Correspondence between shareholders and debtor's counsel indicated the shareholders' impression that the debtor's counsel was working for their benefit and that the entire reorganization proceeding was to exclusively promote the shareholders' interests.

vii. The shareholders were never represented by counsel during the bankruptcy proceedings prior to the confirmation hearings.

In view of the foregoing, the court found a conflict of interest in addition to a failure to disclose a pre-petition retainer and wrongful payment of attorney's fees against that retainer. Furthermore, counsel's services were of questionable benefit to the estate. The court ordered a 50% reduction in fees. The court concluded: "[W]henever counsel for a debtor corporation has any agreement, express or implied, with management or a director of the debtor or with a shareholder, or with any control party, to protect the interest of that party, counsel holds a conflict." *Id.* at 754.

17. An attorney who simultaneously represented the debtor and debtor's sole shareholder did not have an interest adverse to the estate in attempting to sell assets and was entitled to compensation for those services. The attorney in such a situation has the burden of proving that his or her services benefitted the estate, rather than the individual shareholder. *In re Hurst Lincoln Mercury, Inc.*, 80 B.R. 894 (Bankr. S.D. Ohio 1987).

18. *In re Roberts*, 75 B.R. 402 (D. Utah 1987), held that while dual representation of the corporate debtor and its principal owners, who were also debtors, and whose estate was a creditor of the corporate debtor, may be potentially conflicting, such potential conflict does not in itself warrant a denial of fees, but requires further inquiry.

19. A law firm's representation of the debtor and its president was grounds for disqualification, but the firm was entitled to some compensation, as the court found the law firm did not intend to deceive the court. *In re Roger J. Au & Son, Inc.*, 71 B.R. 238 (Bankr. N.D. Ohio 1986).

20. *In re Hoffman*, 53 B.R. 564 (Bankr. W.D. Ark. 1985), held that a conflict exists where the same counsel simultaneously represents a corporate debtor and an individual equity shareholder, who is also a debtor, when the individual is a creditor of the corporate debtor. The court distinguished this situation from one involving multiple business entities which are owned by a single entity, in which case dual representation may be impractical to untangle the debtor's affairs without unreasonable delay and expense.

21. An attorney representing the debtor was disqualified and denied attorney fees for simultaneously representing the debtor and an insider. The court found a significant conflict of interest because the debtor's attorney had also represented one of the debtor's major shareholders who waged a battle to take control of the company. The court determined that the debtor "was effectively without a voice in court." *See In re Chou-Chen Chemicals, Inc.*, 31 B.R. 842 (Bankr. W.D. Ky. 1983).

22. The law firm that represented both the debtor and its sole principal ceased to be disinterested when it sought to assign a lease to the principal and therefore could be denied all compensation and expenses. *See In re Angelica Films 57th, Inc.*, 2000 WL 320395 (S.D.N.Y. 2000).

23. Failure of attorney to disclose in application for retroactive employment by Chapter 11 debtor-corporations that he represented debtors' principals created conflict of interest warranting disgorgement of prepetition retainer. *In re Occidental Financial Group, Inc.*, 40 F.3d 1059 (9th Cir. 1994).

24. The Court in *In re Hot Tin Roof, Inc.*, 205 B.R. 1000 (1st Cir. BAP 1997), held that where an attorney's failed to make adequate disclosures regarding his connection with debtor

and its insiders, his connection with another debtor that he represented, and the adverse interests between the debtor-corporations, the bankruptcy court was correct in terminating counsel's employment in the two cases, denying his employment application in a third case, denying his fee application, and requiring him to disgorge fees already received.

D. Representation of Affiliated Corporations.

For cases considering the ethical dilemmas posed by the multiple representation of affiliated corporations, see the following:

1. In *In re Interwest Business Equipment, Inc.*, 23 F.3d 311 (10th Cir. 1994), the court upheld the denial of an application to employ a single law firm to represent three interrelated Chapter 11 debtors. The inter-company debts placed each estate in a creditor-debtor relationship with the other, and a pre-petition management contract existed between one debtor and another. Accordingly, it was necessary to have separate counsel who could fairly and fully advise each debtor as to its rights and responsibilities.

2. *In re International Oil Co.*, 427 F.2d 186 (2d Cir. 1970), held that intercompany claims, an intercompany guarantee, and the granting of a lien by the parent and three subsidiary companies to another creditor was insufficient to require the estates to have separate trustees and trustee's attorneys.

3. The court in *In re Prudent Holding Corp.*, 153 B.R. 629 (Bankr. E.D. N.Y. 1993) held that counsel for a Chapter 11 debtor was not disinterested and represented interests adverse to the estate as a result of the multiple representation of the debtor's principals and related corporations, against whom the debtor had prima facie claims. These claims were identified

because the debtor's relationship was marked by a commingling of corporate funds and inadequate maintenance of records,

4. The court in *In re Brennan*, 139 B.R. 353 (Bankr. D. Md. 1992), granted counsel's motion for reconsideration subsequent to the court's denial of all compensation where the attorney represented both the corporate debtor in Chapter 7 as well as the corporation's sole stockholder, insider, and guarantor in a Chapter 13. The court said dual representation was permissible so long as the compensation in the Chapter 13 was limited to services in connection therewith, and did not include services for the work on the Chapter 7.

5. Counsel for the trustee in one corporate debtor's case was not precluded from representing the same trustee in the case of a second corporation which had purchased all of the stock of the first corporation, even though the first corporation held a claim against the second corporation, where the counsel's primary objective was to get funds into the estate of the first corporation for the benefit of its creditors. *In re Lyons Transp. Lines, Inc.*, 144 B.R. 32 (Bankr. W.D. Pa. 1992).

6. A law firm could represent a corporation and an individual who was the corporation's president, CEO, and sole shareholder in jointly administered Chapter 11 cases. *In re Professional Dev. Corp.*, 140 B.R. 467 (W.D. Tenn. 1992).

7. In *In re Global Marine, Inc.*, 108 B.R. 998 (Bankr. S.D. Tex. 1987), fourteen affiliated debtors filed Chapter 11 proceedings and were consolidated for administrative purposes, jointly administered and, with one exception, represented by the same law firm. The court found that even though a potential for conflict existed, the firm's representation of several debtors with intercompany claims did not create an actual conflict. The court held that

intercompany claims do not in and of themselves create an impermissible conflict of interest, which would justify disqualification and denial of compensation. The court based its decision on the following factors:

ii. The unity of interest between the holding company and the subsidiaries.

iii. The fact that the debtors had functioned, in effect, as one enterprise, which had been operated for the benefit of the whole.

iv. No demonstration was made of any instance in which the dual representation had caused injury to the estate of the subsidiaries.

8. In *In re Michigan General Corp.*, 77 B.R. 97 (Bankr. N.D. Tex. 1987), reh'g denied, 78 B.R. 479 (Bankr. N.D. Tex. 1987), six affiliated debtors (parent and five subsidiaries) filed a Chapter 11 petition. The attorney represented all of the debtors and had also represented each of the debtors both pre- and post-petition in connection with the bankruptcies and had received over $300,000, immediately before filing, for prior representation. Counsel also represented companies which owned 22.6% of the parent debtor. Furthermore, two of the subsidiary debtors had large pre-petition claims against the parent debtor. The bankruptcy court found that counsel was not disinterested and therefore held interests adverse to the estate. As a result, counsel was disqualified and all compensation was disallowed. The bankruptcy court relied on the following factors in reaching its decision:

i. Counsel was an insider and therefore was not disinterested.

ii. Counsel represented creditors and equity holders with interests materially adverse to the debtors' estates.

iii. Counsel held an adverse interest due to preferential transfers.

iv. Counsel failed to disclose all connections between itself, debtors, creditors and parties in interest.

The District Court upheld the denial of compensation for services rendered prior to the disqualification order, based on counsel's failure to disclose the pre-petition payment of its fees.

9. A law firm was not disinterested where one member of the firm had a co-ownership interest in 80 acres of land with the debtor and the firm was a pre-petition creditor of the debtor. The firm was disqualified for a lack of disinterestedness and a failure to disclose the potential conflicts. *In re Patterson*, 53 B.R. 366 (Bankr. D. Neb. 1985). *But see In re O'Connor*, 52 B.R. 892 (Bankr. W.D. Okla. 1985) (Court allowed employment of attorneys who represented Chapter 11 corporate debtors, as well as debtor's principals, who were majority shareholders of the corporate debtor).

10. The court in *In re Guy Apple Masonry Contractor, Inc.*, 45 B.R. 160, 167 (Bankr. D. Ariz. 1984), held that counsel's dual representation of two related corporate debtors with common ownership would not be discontinued because counsel was intimately familiar with the issues to be resolved and to replace counsel would be counter-productive and unnecessarily expensive.

11. Compensation was denied where the attorney was a pre-petition creditor of the debtor and the attorney formerly represented various related entities of the debtor and the attorney's relationship with those entities was in dispute. Furthermore, a member of the attorney's law firm was designated as assistant secretary of the debtor. *In re B.E.T. Genetics, Inc.*, 35 B.R. 269 (Bankr. E.D. Cal. 1983).

12. The following cases found no conflict of interest because of unity of interest or common ownership and control: *In re O.P.M. Leasing Services, Inc.*, 16 B.R. 932 (Bankr. S.D.N.Y. 1982), *aff'd*, 44 B.R. 1023 (S.D.N.Y. 1984), *aff'd in part and rev'd in part*, 48 B.R. 824 (S.D.N.Y. 1985); *In re International Oil Co.*, 427 F.2d 186 (2d Cir. 1970); *In re Katz v. Kilsheimer*, 327 F.2d 633 (2d Cir. 1964).

E. <u>Representation of Partners</u>.

For cases addressing the conflicts of interest inherent in the representation of more than one entity in a partnership, see the following:

1. The court in *In re DN Assoc.*, 3 F.3d 512 (1st Cir. 1993) held that the fact that counsel for a Chapter 11 debtor proposed plans which would maintain the viability of investments made by the debtor's limited partners, as well as the integrity of the debtor's overall business operation, did not establish any grounds for a conflict of interest which would prohibit payment of attorneys' fees.

2. An attorney for the debtor's general partner was improperly employed as counsel for the limited partnership debtor. A conflict of interest occurred when the general partner purchased the estate's primary asset and received full payment of his claim at the expense of the other unsecured creditors. *In re Downtown Inv. Club III*, 89 B.R. 59 (Bankr. 9th Cir. 1988).

3. In *In re Georgetown of Kettering, Ltd.*, 750 F.2d 536 (6th Cir. 1984), representation of a creditor and debtor in a partnership situation was fatal to an attorney. The Sixth Circuit reversed the Bankruptcy Court and U.S. District Court and denied all fees for the attorney representing inherently conflicting interests.

4. A law firm representing general partners of a Chapter 11 debtor/limited partnership could not be employed as attorney for the debtor. *In re TMA Assoc., Ltd.*, 129 B.R. 643 (Bankr. D. Colo. 1991); *accord In re W.F. Development Corp.*, 905 F.2d 883 (5th Cir. 1990), *cert. denied*, 499 U.S. 921 (1991).

5. An attorney's fees were reduced for failing to disclose the fact that the firm had represented the limited partnership debtor and general partner in pre-petition litigation against the sole limited partner. The order appointing counsel was not vacated, however, because the attorney had already performed significant services which had benefitted the estate and the failure to disclose was inadvertent. Since the firm had provided some services of value, some compensation was in order. *In re D.L. Enterprises*, 89 B.R. 107 (Bankr. C.D. Cal 1988).

F. <u>Other Ethical Issues For Counsel in Closely Held Cases</u>.

1. <u>Disgorgement of Fees, The Ultimate Bad Word in Bankruptcy Fees</u>

i. *See also In re Commercial Financial Services Inc.*, 427 F.3d 804 (10th Cir. 2004) (disgorgement required due to failure to accurately keep hours after employment flat monthly under 11 U.S.C. § 328 was not approved);

ii. *In re Dick Cepek Inc.*, 339 B.R. 730 (9th Cir. BAP 2006) (retainer of C11 professional possibly not subject to disgorgement due to professional's possible secured claim in the retainer);

iii. *In re Veltri Metal Products, Inc.*, 2006 WL 1716732 (6th Cir. 2006) (committee <u>not</u> required to disgorge interim fees due to estate unsecured creditors not receiving a distribution. Case remanded for further consideration of unsecured creditors' committee fees);

iv. *In re St. Joseph Cleaners, Inc.*, 346 B.R. 430 (Bankr. W.D. Mich. 2006) (Chapter 7 Trustee could not obtain disgorgement of debtor's counsel's fees paid in Chapter 11 case under a confirmed plan and final fee order under 11 U.S.C. § 330);

v. *In re U.S. Flow Corporation*, 332 B.R. 792 (Bankr. W.D. Mich. 2005) (amounts "carved out" to pay fees of court approved professionals were not property of estate and were not subject t disgorgement under *Specker*);

vi. *In re World Waste Services, Inc.*, 345 B.R. 810 (Bankr. E.D. Mich. 2006) (discussing disgorgement in context of payment of final fees, holding that disgorgement could be appropriate but extent of disgorgement would have to be litigated).

2. *Services to Two Masters, Not a Good Idea: In Re R&R Associates of Hampton, 402 F.3d 257 (1st Cir.* 2005)

R&R Associates ("R&R") was a general partnership with two general partners, Choate and Gaudette. R&R's only asset was a single piece of commercial real estate.

In 1990, Gaudette retained a law firm ("Law Firm") to transfer $700,000 of his property to several family limited partnerships ("FIP"). The Law Firm later helped Choate transfer a significant amount of assets to other FIPs. Under applicable law, assets and interests in FIPs are extremely difficult to attach by creditors.

Later, in 1991, R&R was forced to file a Chapter 11 proceeding. The Law Firm, in its application to be employed as R&R's Chapter 11 counsel, failed to disclose their prior and <u>ongoing</u> representation of Gaudette and Choate.

During the course of the R&R Chapter 11, the Law Firm stated to the Bankruptcy Court that Gaudette and Choate had sufficient assets to cover any shortfall in R&R's assets. Unfortunately, the Chapter 11 was a total failure and was converted to a Chapter 7. Further, Gaudette and Choate, due in part to their transfers to the FIPs, were in fact unable to cover the asset shortfall in the R&R estate.

The Chapter 7 Trustee requested the general partner's financial records and the Law Firm provided the Trustee with these records without disclosing the FLP's existence or the Law Firm's part in setting up the FLPs.

Ultimately, the Chapter 7 Trustee sued the Law Firm for negligent representation of R&R during the Chapter 11 and breach of their fiduciary duties and sought disgorgement of the Law Firm's $18,87.00 in legal fees paid by R&R to the Law Firm, and $412,000 in other damages representing the unpaid claims in the case.

After two Bankruptcy Court opinions and two appeals to the U.S. District Court (which ultimately affirmed the Bankruptcy Court's dismissal of the Trustee's lawsuit), the Trustee appealed the case to the First Circuit.

The First Circuit <u>reversed</u> the District Court decision, finding:

2. The Law Firm had a duty of "care, candor and unswerving loyalty" to the Debtor;

3. The Law Firm breached these duties to R&R by:

    a. Making uninvestigated representations as to the general partners' net worth;

    b. Assisting the general partners in shielding their assets from creditors;

    c. Failing to advise the Bankruptcy Court of their conflicts of interest.

4. Entry of judgment was appropriate against the Law Firm in the amount of all unpaid claims of the R&R Estate ($412,000) was appropriate.

Throughout the First Circuit's opinion, the Court notes that the Law Firm "affirmatively violated" its fiduciary duty to the Debtor by continuing <u>post-petition</u> to shield personal assets of the General Partners in the FLPs. Given the serious nature of the sanction, this case should serve as a warning to all attorneys not to shield the assets of potential debtors of a chapter 11 debtor.

3. Disclose, Disclose . . . *In re Big Rivers Electric Corporation*, 355 F.3d 415 (6th Cir. 2004)

A cautionary tale about why examiners and trustees should not attempt to obtain undisclosed agreements from creditors in the middle of a case concerning their compensation. Court found that the examiners undisclosed efforts to obtain a fee enhancement violated the examiner's duties of loyalty, disclosure and to remain disinterested and ordered disallowance and disgorgement of all fees even though Examiner brought to the estate an additional $145,000,000.00 to estate from his efforts.

4. Case to Remember: *In re V&M Management, Inc.*, 321 F.3d 6 (1st Cir. 2003)

In V&M, the sole shareholder and former director of the debtor subchapter s corporation filed a state court lawsuit against chapter 11 debtor's law firm and bankruptcy trustee. Case was removed to Federal Court and was dismissed due to Bankruptcy Court's determination in the Chapter 11 case that there was no value to Debtor's equity interest.

5. And Again, Who is Your Client? *Bergin* v. *Eerie World Entertainment, LLC*, 2003 WL 22861948 (S.D.N.Y. Dec. 2, 2003)

Law firm disqualified as counsel for a chapter 11 debtor for (1) either representing the debtor's principal [or at least being severely confused as to who his client was]; (2) accepting payments of professional fees from the debtor's principal; and (3) ignoring causes of actions against associates of the principal.

6. II: Mutineers Continue to Win. *In re The Phoenix Group Corporation*, 305 B.R. 447 (Bkrtcy N.D.Tx 2003).

Chapter 11 Debtors' counsel represented the Debtors in a hotly contested Chapter 11 proceeding. Counsel for the Debtors moved twice to be permitted to withdraw for ethical reasons. In one of the motions the Debtors' counsel noted that the Debtors' principal was demanding that Debtors' counsel take actions and pursues strategies that Debtors' counsel found to be "legally and ethically improper. The Mutiney second motion to withdraw was granted.

The Debtors' counsel ultimately filed a final fee application and the principals of their former client, allegedly on behalf of the Debtors, objected arguing (1) the Debtors' counsel failed to properly object to the plan of another related Chapter 11 debtor ("Related Case"); and (2) the Debtors' counsel failed to pursue the appointment of a trustee in the Related Case.

The court overruled the Objection after finding that:

1. The Debtors could not get along with any attorney, as six of its 20 largest creditors were law firms;

2. The Debtors did in fact attempt to require their counsel take improper actions; and

3. The Debtors' counsel properly exercised its professional judgment in deciding not to pursue the actions which were the basis of objection to the fee application.

7. Obey Your Master! *In re Texasoil Enterprises, Inc.*, 296 B.R. 431 (Bkrtcy. N.D.Tx 2003)

Debtors' counsel ordered to disgorge $6,500 of $15,000.00 retainer for failing to have the Debtors comply with the Court's 11 U.S.C. § 1107 Order which limited the Debtors authority to operate post petition.

8. Make (and Disclose) Waivers: *In re Jore Corporation*, 298 B.R. 703 (Bkrtcy. D. Mont. 2003)

Chapter 11 debtor's law firm's fee application was denied and law firm was ordered to disgorge all fees and expenses previously paid (except for expenses relating to service of pleadings under case management order) due to Debtors' counsel's failure to fully disclose material limitations in a conflict waiver which Debtors' counsel had with the Debtors primary secured lender. The improper disclosure and conflicts of interest included conflicts with the secured lender on the details of professional fee carve outs for debtor's counsel.

9. A Single Screen: *In re Angelika Films 57th, Inc.*, 227 B.R. 29 (Bkrtcy. S.D. N.Y. 1998).

In this case, the debtor's Chapter 11 counsel also represented the debtor's owner in numerous matters, including his divorce and a related replevin action with his former spouse and a major creditor of the debtor. The Chapter 11 attorneys were employed over the objection of the U.S. Trustee and the debtor's former spouse. During the Chapter 11 case, the debtor entered into an agreement to use its "good faith" efforts to market a valuable lease by a certain date, and if a motion to assume or assign the lease was not filed by that date, the debtor agreed to the appointment of a Trustee. After the debtor failed to get an extension of time to market the lease, the debtor's owner offered to "purchase" the lease for $100,000.00, 20% of its appraisal value of $500,000.00. The motion to assume had numerous other provisions favorable to the debtor's owner. The Bankruptcy Court rejected the motion to assume or assign the lease, finding it was filed in bad faith, and appointed a Chapter 11 Trustee. The District Court affirmed this decision.

Ultimately, the estate, through the Chapter 11 Trustee, was able to sell the lease for $1,000,000.00, ten times what the debtor's principal offered to purchase the lease for in the assumption and assignment motion. After the sale, the Chapter 11 counsel moved for approximately $491,000.00 in fees and ultimately entered into a settlement agreement for a reduced amount of fees with the other parties in the case. The Court, exercising its powers to review professional fees, denied all fees of the debtor's Chapter 11 counsel in this case, finding that the Chapter 11 counsel had abandoned its fiduciary duty to the debtor by its actions in this case. The Court specifically found that the attorneys had failed to fully inform the Court about the assumption motion and had represented primarily the debtor's owner's interests throughout the bankruptcy. This is an important case, because the Court even denied fees that were for services beneficial to the debtor.

10. Mutiny or Heroism? *In re JLM, Inc.*, 210 B.R. 19 (BAP 2d Cir. 1997).

Counsel for the Chapter 11 debtor, JLM, Inc., was faced with an objection to its fees by the debtor's owner for their alleged refusal to obey the orders of the debtor's owners. The facts of this case are unusual, to say the least. At the commencement of the Chapter 11 case, the debtor was owned by two individuals who had also filed individual Chapter 11 petitions. The debtor's stock was pledged by the individuals to the primary secured lender of JLM. Through the individuals' Chapter 11 plans, the secured lender obtained direct ownership of all of the stock of JLM. In January of 1996, the secured creditors, some three months after JLM's bankruptcy and after the secured lender had discovered its security interest in JLM's personal property had lapsed, ordered the debtor's Chapter 11 counsel to dismiss the JLM Chapter 11 case, so it could perfect its lapsed security interest. The Chapter 11 counsel refused the direction and vigorously opposed the secured creditors'/owner's actions to dismiss the case or obtain stay relief to replace the debtor's management. Ultimately, the Bankruptcy Court ruled the secured creditors had the authority to operate the debtor, but found its actions in attempting to dismiss the Chapter 11 violated its fiduciary duty to all the estate creditors and appointed a Trustee. When debtor's counsel filed its final fee application, despite almost universal support, the Bankruptcy Court denied counsel's fees, ruling the Chapter 11 counsel was not entitled to any fees, as it represented the individuals who previously owned the debtor in opposing the secured creditors' actions and not JLM. The BAP reversed, finding that JLM's Chapter 11 counsel had apparently acted properly in opposing the actions of the secured creditor/owner, and remanded for a determination of whether the counsel's actions benefited the estate.

11. Climbing Mount Everest and Finding Yourself Disinterested: *In re 7677 East Berry Avenue Associates, L.P.*, 419 B.R. 833 (Bankr. D. Colo. 2009)

This case is an example of a court, which in appropriate circumstances, will find that numerous but minor and reasonable connections with the Debtors principals and other parties, potential preference claims and claim issues will not disqualify an attorney from employment under 11 U.S.C. § 327.

In this case the Debtor, 7677, was a luxury property developer in Colorado. In its schedules, the value of its assets exceeded the value of its debts.

In this case, the proposed counsel represented pre-petition each of the Debtor entities, the Debtor's owner and various related non-debtor entities. The court found that the prior representation of the owner and of affiliated non-debtor entities were not disqualifying as the prior representation of the owner was minor and all affiliated entities signed a form of waiver letter, called an "acknowledge of duty of loyalty" in favor of the Debtor.

The court also found that: (1) the proposed counsel's payments from the Debtors in the 90 days prior to the bankruptcy were not "facially plausible" preference claims and therefore, not disqualifying; and (2) the proposed counsel's sale of its claim for $662,843.93 in pre-petition fees to a related non-debtor company did not disqualify the proposed counsel from being retained by the Debtor. The court noted that special counsel and/or the committee could play a significant role in preventing any potential conflicts in this case from becoming real conflicts.

12. Donuts May Lead to Lawsuits: *In re Food Management Group, LLC*, 380 B.R. 677 (Bankr. S.D.N.Y. 2008)

In this case, the Debtor was a troubled franchisee of Dunkin Donuts ("DD"). Prior to the bankruptcy, the parties controlling the Debtors entered a settlement which contemplated a sale of the DD franchises and that the current owners could have no involvement with a purchaser.

After the Chapter 11 was filed, Debtors counsel allegedly failed to disclose that the current owners were involved with a proposed purchaser of the Debtor's assets, including the DD franchises. The counsel also returned a $2.1 million deposit for that proposed sale without prior bankruptcy court approval. The court refused to dismiss a lawsuit against Debtor's counsel for negligence, malpractice and other breaches of duties owed to the Debtors and stated that due to Debtor's counsel's fiduciary duty to the Debtors, the doctrine of *in pari delicto* would not prevent the lawsuit.

13. EZ Golf Not So Easy Disclosure: *In re EZ Link Golf, LLC*, 317 B.R. 858 (Bankr. D. Col. 2004)

In this case, EZ Links Golf, Inc. ("Inc.") a non-debtor entity, paid the Debtor's proposed counsel's retainer. Further, the proposed counsel disclosed that it could not sue certain critical parties which it represented pre-petition. Based on these facts, the court refused to employ the proposed counsel. The court noted that while the proposed counsel ultimately made full disclosure, that disclosure was only completed over 1½ months after the case was commenced and that the court could have ruled earlier had full disclosure been made earlier.

14. How to Get Out:: Noisy Withdrawals:

One of the greatest professional nightmares an attorney can face is the discovery, during litigation or a business transaction, that the people running your client are crooks and have lied to you. Such a discovery will immediately cause the attorney to seriously consider whether she should withdraw from representation of the debtor. Assuming that your client (or if you represent an entity, the individuals running your client) does not take steps to rectify their improper actions, withdrawal is probably inevitable and required. At such a time, many attorneys may think of the famous (or infamous) "noisy withdrawal" as a way out. Unfortunately, there is no direct case law authority in Kentucky which describes what constitutes a noisy withdrawal or which explains exactly how a noisy withdrawal may be accomplished without violating other ethical rules. This article attempts to address the question of what a noisy withdrawal is, how a noisy withdrawal can be accomplished, and what steps an attorney must take to ensure that her noisy withdrawal is effective.

Please note that it is beyond the scope of this article to determine what your noisy withdrawal obligations are under the Sarbanes-Oxley Act. See Ryan Morrison, Note, Turn Up the Volume: The Need for a Noisy Withdrawal in a Post Enron Society, 92 Ky. L.J. 279 (2003-04).

The Formal Opinion 92-366 - the Mother of "Noisy Withdrawals" in Non Litigation Settings.

The genesis of what constitutes a "noisy withdrawal" can be found in ABI Formal Opinion 92-366 ("Opinion 92-366"). Under that opinion, a noisy withdrawal is a withdrawal from representation of a client accomplished by a disavow of work product provided by the attorney. The ABA Committee on Ethics and Professional Responsibility ("ABA Committee") concluded that an attorney could only make a "noisy withdrawal" if the attorney's work product was being used or was intended to be used in a future fraud or criminal activity. Opinion 92-366 stated that a noisy withdrawal was a permissive step the attorney could take, not a required step. In fact, the ABA Committee further held that if a fraud had already been completed, or that the attorney did not know or reasonably believe that the client would continue the fraud or commit a future fraud through the use of the attorney services or work product, the attorney could not make a noisy withdrawal.

While Opinion 92-366 is important to understand the ethical framework surrounding a noisy withdrawal, it is not directly applicable to most typical situations. In a fact pattern presented to the ABA Committee, the fraud involved the use of an attorney's opinion letter which was based on false evidence given to the attorney by his clients. The opinion letter was used to obtain a loan and was not used in proceedings before a court. Indeed, the Opinion 92-366 noted that while the ABA Committee had considered the ramifications of Rule 1.6, Ky SCR 3.130 (1.6) of the Model Rules of Professional Conduct (hereinafter "Rule"), given the facts submitted to the ABA Committee, it did not have to address the issue of whether Model Rule 3.3, Ky SCR 3.130 (3.3) requiring the disclosure of the fraud to the tribunal would require a noisy withdrawal or even a more explicit disclosure. See *Brown v. Commonwealth*, 226 S.W.3d 74 (Ky 2007) (discussing indirectly noisy withdrawal requirements in criminal and civil cases, involving false testimony).

Strike Up the Band, a Noisy Withdrawal in Litigation.

Representation of a client during a trial, unlike many legal services provided by attorneys in civil practice, generally involve activities which are overseen by a tribunal. Therefore, unlike the situation governed by Opinion 92-366, Model Rule 3.3 is almost always implicated when the question of client fraud arises during actual litigation. It is the difficulties in balancing an attorney's duties to keep certain information confidential under Rule 1.6 with a duty to disclose fraud on a tribunal under Rule 3.3 which places counsel in such a difficult position.

In many respects this difficulty is mis-perceived. The vast majorities of cases, including Brown, clearly indicate that a counsel's duty to the court under either Rule 3.3 or under the common law duty of counsel as a "officer of the court" will override his duty to maintain client confidentiality under Rule 1.6. However, even if counsel has a duty to disclose fraudulent activity to a court, there is no clear cut rule as to how that disclosure should be made. Indeed, although Rule 3.3 does require disclosure of facts necessary to prevent fraud by a client on a tribunal, attorneys should not ignore the dictates of Rule 1.6 or Rule 1.16 (termination of representation) in a frenzied effort to comply with Rule 3.3.

Rule 3.3 Comment 11, "Remedial Measures," offers some important guidance on this point. Comment 11 states in pertinent part "if perjured testimony or false evidence has been offered, the advocate's proper course ordinarily is to redemonstrate with the client confidentially. If that fails, the advocate should seek to withdraw if it will remedy the situation. If withdrawal will not remedy the situation or is impossible the advocate should make disclosure to the Court." It would seem from this Comment that immediate disclosure of fraud to the Court is not the required or even the preferred ethical course of action in a situation where an attorney has knowledge of a client's fraud and less drastic action than disclosure will be effective in alerting the tribunal of the problem. However, steps must be taken to remedy any fraud perpetuated by a client on a Court. Therefore, where a client refuses to correct the false testimony or disclose the fraud, in civil litigation a noisy withdrawal may very well be the preferred course of action in order to disclose the fraudulent conduct. In criminal cases, under Brown, how to alert the court is a far more difficult question.

The Female Nordic Opera Star Begins Her Final Aria: Conclusion.

Exposing fraud committed by a representative of a client is a difficult ethical task, especially given the fact that the people who have committed the fraud are likely the ones who hired you and from whom you take your orders. A noisy withdrawal gives you a middle ground on which to fulfill your ethical and fiduciary duties to the court and the rules of professional conduct without having to disclose a client's confidences directly to the tribunal or other parties. Hopefully, the ethical nightmare discussed above will not happen to you, but in the event that you are faced with such an ethical disaster, be sure to consider the loud, proud and noisy withdrawal as a way out of your dilemma.

15. No Good Deed Goes Unpunished: Lawsuits against attorney

A number of recent cases have addressed issues related to lawsuits against Chapter 11 debtors' counsel for breaches of their fiduciary duty. Under amended 28 U.S.C. § 1334(e) nearly all of these cases will have to be heard in Federal Court as the Federal Court has exclusive jurisdiction over all claims involving 11 U.S.C. § 327 and rules related thereto.

a. *Kittay v. Kornstein*, 230 F.3d 531 (2nd Cir. 2000). (Court permitted breach of fiduciary duty suit to go forward on complaint that special counsel to the debtor harmed debtor's bankruptcy estate by actions related to simultaneous representation of creditor claiming estate assets. Court also held that representing multiple adverse clients is not a cause of action in and of itself.)

b. *First Interstate Bank of Az v. Murphy, Weir & Butler*, 210 F. 983 (9th Cir. 2000). (Law firm was sued because it hired a judge's law clerk and the clerk continued to work on its future employer cases in violation of several portions of the Code of Judicial Conduct and Code of Conduct for Law Clerks. After discovery of this problem, the judge recluse himself from the case and the new judge ordered a new trial, after which the hiring law firm's client received a less favorable ruling. The Ninth Circuit held that it was the judge's and law clerk's duty to take proper ethical action, and that law firm had no independent duty to disclose or take steps to ensure judicial Codes of Conduct are followed. Good case to read if you are hiring a judge's law clerk.)

c. *In re Verit Industries, Inc.*, 172 F.3d 61 (9th Cir. 1999) (unpublished decision available on WestLaw). (Discussing whether settlement agreement released debtor's pre-petition attorney from actions for legal malpractice and breach of fiduciary duty cases of action).

d. *ICM Notes, Ltd. v. Andrews & Kurth, LLP*, 278 B.R. 117 (S.D. TX. 2002), aff'd w/o opinion, 324 F.3d 768 (5th Cir. 2003). (Recent case which reaffirms the doctrine that Chapter 11 professionals do not owe a fiduciary duty to specific creditors. Court dismissed claim against debtor's counsel for breach of fiduciary duty by creditor which was attempting to acquire the debtor through a plan of reorganization.)

e. *Matter of RDM Sports Group, Inc.*, 260 B.R. 915 (Bankr. N.D. GA. 2001). (Chapter 11 Trustee has right to jury trial in

Bankruptcy Court on suit against debtor's professionals for breach of fiduciary duty).

f. *In re C Power Products*, 230 B.R. 800 (Bankr. N.D. TX. 1998). (Discussing issues related to standing to bring legal malpractice and breach of fiduciary duty claims).

g. *Borden v. Clement*, 261 B.R. 275 (Bankr. N.D. Ala. 2001). (Dismissal of lawsuit against Chapter 11 debtor's counsel by owner of Chapter 11 debtor, alleging that attorney breached fiduciary duties to owner and was guilty of malpractice. Important discussion on how to withdraw from case.

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practice. Moreover, his underlying assumption seems to be that matching anticipated capital expenditures to depreciation means no new investment will be made. That does not appear to be accurate. Rather, it means that the level of new investment going forward will be at the same level as in the past. In any event, in performing his own valuations, the Examiner increased the capital expenditure projections used by CEC's original financial advisors as appropriate. Deloitte, CEC's auditors, also has explicitly stated that CEC's use of the depreciation amount as the amount for projected capital expenses in its own valuations was appropriate. Professor Lehn also advocates reliance on only one method of valuation – the discounted cash flow (DCF) method – while customary valuation methodology considers three valuation methodologies, including the DCF method. If that approach was followed by the financial advisors retained by CEC in connection with the valuations they performed, in a number of the challenged transactions the advisors would not have been able to opine that the consideration met the applicable "fairness" or "reasonably equivalent value" standard since the DCF calculations yielded the highest valuation numbers among the three methods.

C. Attorneys

Prior to July 2011 CEOC had been represented by O'Melveny & Myers LLP (OMM), who had represented the Sponsors in the LBO. The lawyers involved in that representation moved to Paul, Weiss, Rifkind, Wharton & Garrison LLP (Paul Weiss) in late spring 2011, and since that time Paul Weiss represented CEOC in virtually every transaction investigated by the Examiner. In each of these transactions, first OMM, and then Paul Weiss, also represented CEC, CEOC's then 100% shareholder. During this entire period Apollo also was a very significant client of Paul Weiss on matters unrelated to Caesars. This fact was not known to the independent directors of CEC. The Caesars General Counsel was aware of this, and believed that Paul Weiss was more responsive to the Apollo (and TPG) directors than they were to him. Neither OMM nor Paul Weiss has identified any retention letter relating to its representation of CEOC, and it appears that none exists.

Certain creditors raised questions about the role of Paul Weiss in various of the transactions which were investigated. In analyzing the relevant transactions, the Examiner thus considered whether there are any claims that CEOC has against Paul Weiss.[20] In this regard, issues of conflict of interest, malpractice and aiding and abetting breach of fiduciary duty were analyzed. While the Examiner has concluded that probably by the Fall of 2012 and more clearly by the Fall of 2013 Paul Weiss did have a conflict of interest in representing both CEOC and CEC in at least some of the relevant transactions, for the reasons discussed below the Examiner believes that any claim by CEOC against Paul Weiss would be weak.

It is important to understand that it is not unusual for lawyers to represent portfolio companies of their private equity clients, although doing so can raise some ethical issues once there are public shareholders. Nor is it unusual for the same law firm to represent a parent

[20] Given when their representation ended, the Examiner does not believe there are any potential claims against OMM.

corporation and its 100% owned subsidiary. In each of these circumstances, however, the situation changes once the company being represented becomes insolvent.

Once insolvent, a company's residual beneficiaries change from its equity holders to its creditors. When the subsidiary is insolvent, actions that may be in the interest of the parent may not be in interest of the subsidiary. Nonetheless, there certainly are circumstances where a parent and its insolvent subsidiary can be represented by the same counsel, such as when they are litigating against a common defendant. The situation is different, however, when the parent and insolvent subsidiary are on opposite sides of the same transaction and the same law firm purports to represent both entities. In that case the interests of the two entities diverge. And, once such a divergence of interest occurs, a lawyer can only undertake or continue representing multiple clients if it is clear that the lawyer can competently represent both clients and if both clients provide informed consent based on a full disclosure by the lawyer of the issues involved in the simultaneous representation.[21] Here it does not seem that either requirement was satisfied. The issues then are when was Paul Weiss adequately on notice of CEOC's potential insolvency, and in what transactions did such a divergence of interest occur.

The two instances where the interests of CEC and CEOC most clearly diverged were in the negotiations over the CERP transaction and in the creation of CES. As to CERP, the transaction involved the sale of assets by CEOC to CEC which then transferred them to the new CERP entity, a 100% owned CEC subsidiary. Thus by representing both CEC and CEOC, Paul Weiss was representing both the buyer and the seller in this transaction. A seller's counsel might have considered a variety of issues. One mixed legal and business issue involved in the transaction was the extent to which certain purported indirect benefits to CEOC from the transaction could or should be counted as consideration. These indirect benefits accounted for over 70% of the consideration received by CEOC. While whether to consider these indirect benefits as consideration was ultimately a judgment made by Perella Weinberg, the financial advisor involved in the transaction, whether on the facts of this case it was appropriate to do so also involved a legal issue (which Paul Weiss in fact analyzed). A zealous advocate for CEC would argue that including these benefits as consideration was legally justified. A zealous advocate for CEOC could well have taken the opposite position. This issue is discussed at length in Section VIII.C, *infra*.

The creation of CES in the Spring of 2014 involved the transfer to CES by CEOC of a broad license to Caesars' unique loyalty program, Total Rewards, as well as its enterprise-wide management responsibilities. CES then licensed Total Rewards to CERP and Growth. *See* Sections VIII.D & F, *infra*. The expressed reason for the creation of CES was concern over a possible CEOC bankruptcy. How to structure the rights of CEOC, CERP and Growth under this structure was a complex task involving competing interests of CEC (which owned CERP and had a 58% interest in Growth) and CEOC. Paul Weiss represented CEC and CEOC in these negotiations; the negotiations also included counsel for a special committee of outside CEC directors and counsel for a similar committee of CAC directors. Paul Weiss thus represented both the licensor and the owner of the sublicensee. A clear example of the adversity of CEC and CEOC in this transaction was the inclusion in the CES Agreements of provisions under which

[21] *See* N.Y.R. Prof'l Conduct 1.7.

CEOC would forfeit all its governance rights in CES should it file for bankruptcy, which was then a known risk, and indeed the rationale for the transaction. A zealous advocate for CEOC most likely would have resisted such a provision. The Paul Weiss partner involved in the transaction explained the rationale for its inclusion as being the "penalty" "they" felt needed to be imposed on CEOC should there be a bankruptcy risking CEOC's ability to perform under the agreement because otherwise that would be unfair to the other CES members.[22]

The extent of the adversity in the Growth, Four Properties and B-7 Transactions is somewhat less pronounced. In the first two cases, properties owned by CEOC were being sold to Growth, in which CEC had a majority ownership interest, and where CEC special board committees were purportedly acting on behalf of CEOC. Similarly, in the B-7 related transactions, CEC and Apollo negotiated the terms of new CEOC loans and the modification of the terms of existing loans, including the release by CEC of its guarantee of certain CEOC debt. (*See* Section IX.B, *infra.*) While CEC and CEOC shared a common interest in aspects of these transactions, their interests were not completely aligned and a separate CEOC counsel could have considered whether independent directors at CEOC were required to evaluate whether proceeding with these transactions was in the interest of CEOC and its creditors. Moreover, in the B-7 Transaction a significant issue was the release of CEC's guarantee of CEOC's bond debt where the interests of CEC and an insolvent CEOC could easily have diverged. While the divergence of interest in these transactions is less clear, the fact remains that in those transactions no one was focused on CEOC's interest alone as opposed to how transactions impacted Caesars as a whole.

Since, as discussed above, CEOC had been insolvent since December 31, 2008, the real issue is when did, or should have, Paul Weiss recognized that there was a sufficient risk of CEOC being insolvent to trigger any of the above potential conflicts. Lawyers, after all, are not financial advisors and have neither the responsibility, nor likely the skill, to perform solvency analyses themselves. But whether an entity is solvent is a mixed question of law and fact.

Here Paul Weiss has argued first that it did not believe a conflict existed because CEC and the Sponsors were proposing transactions which were designed to benefit CEOC as well as CEC, and CEOC was paying its bills as they came due. A conflict, they argued, would only arise when they understood that a bankruptcy was sufficiently probable which, they say, was not the case at the time of any of these transactions. Paying current bills, however, is not the legal definition of solvency, and saying transactions were in the interests of creditors begs the real question since an independent counsel might have assessed the merits of these transactions, from CEOC's perspective, differently. Moreover, insolvency creates a potential conflict before a bankruptcy becomes probable.

Paul Weiss also argues that it was not on notice of CEOC's insolvency. Assessing when it was on notice of CEOC's potential insolvency is a complex issue. Based on the following, the earliest there is a reasonable case that it was on such notice is in the Summer/Fall of 2012 and a stronger case exists it was on notice in the Fall of 2013:

[22] This provision was amended on the eve of CEOC's Chapter 11 filing.

- Paul Weiss was intimately involved since 2011 in all aspects of CEC's response to the financial problems confronting CEC and CEOC, and the OMM partners who joined Paul Weiss in 2011 had been doing so since 2009.

- As discussed above, beginning in 2012 CEC's securities filings explicitly stated it would be unable to pay debts maturing in 2015.

- In June 2012, Paul Weiss was doing analyses of the potential implications of a CEC/CEOC bankruptcy on what became the Growth Transaction. While doing such analyses for a highly levered company is neither unusual nor proof of insolvency, the entire premise of the Growth Transaction was the very weak financial condition of CEOC.

- At least one Paul Weiss partner had in his possession an October 2012 Apollo presentation which made clear that absent an increase in CEOC's EBITDA from $1.4 billion to $2.2 billion – an extraordinary leap – CEOC would have negative cash flow every year. That same deck made clear CEOC could not pay maturing debt in the coming years.[23]

- In connection with the CERP Transaction, in July 2013 Paul Weiss did research on the implications of a CEOC insolvency.

- Numerous Paul Weiss partners had in their possession an October 2013 Caesars analysis which states that CEOC then was billions of dollars short of being able to pay debt maturities in the coming years.

- In October 2013, Paul Weiss was doing legal analyses of bankruptcy risks associated with transactions being considered by Apollo and advising on the implications of a CEOC insolvency on directors' fiduciary duties.

- In November and December 2013, Paul Weiss was advising Apollo on the potential operational impacts of a CEOC bankruptcy.

- In late 2013 or very early 2014, Paul Weiss was recommending independent directors be considered for CEOC because of the financial challenges relating to CEOC's debt or, potentially, a bankruptcy filing. It is difficult to argue that CEOC would need independent directors, but not its own counsel.

None of these facts may constitute definitive proof that CEOC was insolvent. Absent doing an actual solvency analysis, which Paul Weiss did not recommend, they are, however, plain indicia that CEOC was insolvent. Based on these facts, the Examiner believes there is a reasonable case that a Court would find that a conflict existed in one law firm representing both CEC and CEOC in at least the CERP and the CES transactions, if not all of the 2013-2014 transactions through June 2014.

[23] There are multiple versions of the presentation. The version that was in Paul Weiss' possession was the one that went to Gary Loveman.

The existence of a conflict, however, does not automatically create liability. First, based on the evidence any claim against Paul Weiss for aiding and abetting a breach of fiduciary duty by either CEOC's directors[24] or CEC would be weak. For there to be aiding and abetting liability there needs to be a "knowing participation" in the breach.[25] A lawyer providing routine legal services does not meet that standard.[26] Though difficult, however, pleading such a claim is not theoretically impossible.[27] Delaware courts, however, have found lawyers potentially liable for aiding and abetting where they were alleged to have affirmative knowledge of some fraud or where their involvement in the breach went beyond their role as counsel.[28] This simply is not the case here.

Even if a disabling conflict did exist, that would not by itself give rise to a claim for malpractice. *Schafrann v. N.V. Famka, Inc.*, 14 A.D.3d 363, 364 (N.Y.A.D. 2005). To establish liability in the non-aiding and abetting context, New York law would require clear proof that the conflict caused non-speculative damages.[29] Establishing that in this case would be difficult. For example:

- In the Growth and Four Properties Transactions, special committees were established at the CEC level and it would be speculative to conclude that a different result would have occurred if such committees were created at CEOC;

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[24] This would be a Delaware law issue.

[25] *In re Nine Systems Corp. Shareholders Litig.*, 2014 WL 4383127, at *48 (Del Ch. Sept. 4, 2014).

[26] *Heartland Memorial Hosp., LLC v. McGuire Woods, LLP*, 518 B.R. 491, 503-4 (N.D. Ill. 2014); *Sample v. Morgan*, 935 A.2d 1046, 1065 (Del. Ch. 2007)("[i]n most fiduciary duty cases, it will be exceedingly difficult for plaintiffs to state an aiding and abetting claim against corporate counsel").

[27] *Sample*, 935 A.2d at 1065 ("Delaware has no public policy interest in shielding corporate advisors from responsibility for consciously assisting the managers of Delaware corporations in breaching their fiduciary duties. If well-pled facts can be pled that support the inference that a corporate advisor knowingly assisted corporate directors in breaching their fiduciary duties, Delaware has a public policy interest in ensuring that its courts are available to derivative plaintiffs who wish to hold that advisor accountable to the corporation.").

[28] *See Sample,* 935 A.2d at 1065 (Del. Ch. 2007); *CMS Inv. Holdings, LLC v. Castle*, C.A. No. 9468-VCP, 2015 WL 3894021, at *21 (Del. Ch. June 23, 2015); *Royal Indemnity Co. v. Pepper Hamilton LLP*, 479 F. Supp. 2d 419, 431 (D. Del. 2007); *but see Zazzali v. Hirschler Fleischer, P.C.*, 482 B.R. 495, 519 (D. Del. Bankr. 2012); *In re Brown Schools*, 368 B.R. 394, 413 (D. Del. Bankr. 2007).

[29] To prevail in a malpractice action under New York law, a plaintiff would have to establish that Paul Weiss failed to exercise the ordinary reasonable skill and knowledge commonly possessed by a member of the legal profession, and that the firm's breach of that duty proximately causes the plaintiff to sustain actual and ascertainable damages. *Carrasco v. Pena & Kahn*, 48 A.D.3d 395, 396 (N.Y.A.D. 2008).

- In connection with CES, the "penalty" provision described above was eliminated on the eve of bankruptcy, and concluding that other provisions of the relevant agreement would have been different again requires a fact finder to engage in speculation; and

- In CERP it is difficult to know whether a CEOC attorney advocating that the indirect benefits should not be considered would have impacted the assumptions that were provided to Perella for its opinion or Perella's conclusions; Perella had its own counsel to consult with on the issue and came to the considered view that they did provide value to CEOC.[30]

In sum, while a conflict existed which Paul Weiss should have recognized, any claim against Paul Weiss for damages would be weak. Although the conflict was real, and Paul Weiss lawyers should have recognized the need for independent directors and advisors at CEOC by no later than late 2012 – early 2013, and advised its clients accordingly,[31] the evidence does not support a conclusion that Paul Weiss lawyers knowingly acted at any time to injure or prejudice CEOC or its creditors.

D. Remedies

This Report identifies a number of potential fraudulent transfer claims. The remedy for such a claim can include either an order for a return of the property or money damages. In practice, courts most often award damages but that is in part due to the fact that this is the most common remedy sought by plaintiffs. Where valuing an asset is particularly difficult, that is a factor that could cause a court to order return of the property. In general, this Report identifies the remedies available under particular claims but does not predict how a court would exercise its discretion in crafting a remedy. Where monetary damages can be calculated, the Report does so.

If the value of the property has increased since the time of the fraudulent transfer, the monetary remedy would be for the value of the property at the time of the judgment as opposed to the value at the time of the transfer. A good faith transferee would be entitled to a lien in the amount of the cost of any improvements which contributed to the increase in value. A good faith transferee also is entitled to a lien for any consideration paid.

The Examiner has not computed the current value of the properties subject to fraudulent transfer claims. Instead, his damage calculations are based on the value of the properties at the

[30] Perella told the Examiner that it never focused on the 2010 Management and Shared Services Agreements which were relevant to the validity of those assumptions. A separate CEOC counsel might well have brought those agreements to their attention.

[31] Paul Weiss' conflict, and failure to advise CEC and CEOC of the need for independent directors and advisors and the fraudulent transfer and other risks arising out of CEOC's financial condition and unsustainable debt loan sooner, are factors that a court would likely consider in assessing any reliance on advice of counsel defense that may be asserted by or on behalf of CEOC's directors, CEC or the Sponsors.

time of the transfer, which is the same valuation used to determine whether fair or reasonably equivalent value was provided in connection with the transfer. Calculating new valuations would require extensive additional work and would need to be based on the most recently available results and projections. Moreover, if ultimately there is litigation, the correct current number would need to be calculated as of the time of any future judgment. As discussed above, the transferees of these properties have argued as to a number of them that the value has not increased, and indeed is lower.[32]

Remedies for breach of fiduciary duty[33] and aiding and abetting are joint and several and typically determined on an out-of-pocket loss basis. Courts have wide discretion in fashioning equitable remedies, and in appropriate cases have awarded rescission or rescissionary damages (including potentially lost profits). A complete discussion of the legal standards applicable to remedies can be found in Appendix 5, Legal Standards, at Sections VI, XI.A.6 and XI.B.3.

E. The 2009-Mid 2012 Transactions

Three transactions during the 2009-mid 2012 period were investigated. Two of them involved the structuring of a business venture focused principally on online poker and the WSOP brand (the 2009 and 2011 WSOP transactions). These transactions did not address CEOC's balance sheet issues; rather they involved how to structure a business venture involving the transfer of a CEOC asset to a new subsidiary of CEC. The third transaction – the 2010 CMBS Amendment – was designed to address financial issues confronting CEC and CMBS, but transferred some CEOC assets (trademarks) for no consideration. During this period, Apollo also implemented a series of financial transactions to address balance sheet issues, including a significant exchange offer in the Spring of 2009.

1. The 2009 WSOP Transaction

In May 2009, through a complex series of steps, CEOC transferred to CIE, a newly created subsidiary of CEC, its WSOP existing sponsorship, media and licensing business and rights in the WSOP trademark and related intellectual property (WSOP Trademark and IP), and received back a license which allowed it to continue to use the WSOP Trademark and IP for in-person WSOP tournaments and in connection with the sale of WSOP branded products at CEOC's and its affiliates' properties.[34] CEOC also received preferred shares in a holding company with a stated value of $15 million. The purpose of creating CIE was to allow it to use the WSOP Trademark and IP as the basis for creating an online poker business. Online poker was viewed by some at Caesars (including CEO Loveman) as a potentially multi-billion dollar opportunity if legalized by the federal government, although the ability to secure such legislation

32 If the value is lower, CEOC would still be entitled to the value at the time of transfer.

33 In addition, breach of fiduciary duty claims against CEOC directors pre-June 27, 2014 are principally premised on the failure of transactions to satisfy the entire fairness doctrine rather than on the subjective bad faith of those individuals.

34 The Las Vegas based WSOP tournament, which was the primary tournament, was actually held at the Rio, a CMBS property. CEOC received no compensation from the Rio for allowing it to host the tournament.

Has HAL 9000 Finally Arrived? *Taylor*[1] and Computers as Clients

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Straight & Narrow I

When I was young (in 1968), I saw the movie *2001: A Space Odyssey*.[2] The "villain" in this movie was super computer, an apparent artificial intelligence, "named" HAL 9000, which, in its own words, was "foolproof" and incapable of error.[3] It controlled almost all of a spaceship's functions on a long journey to Jupiter. It ultimately murdered most of the ship's crew in a failed attempt to save its "life."

Why does this iconic film have anything to do with bankruptcy ethics? Well, in *In re Taylor*, computers appeared, to both the bankruptcy court[4] and the Third Circuit,[5] to be acting as the client of the two creditors' law firms.

Here Is the Information You Require, Dave

C.R. "Chip" Bowles, Jr.

The origin of the *Taylor* opinion arose from a fairly simple dispute between the Taylors (the debtors) and the creditor holding the mortgage on the debtor's home (the secured creditor): whether the debtors were required to pay flood insurance on their home as part of their mortgage payments. This straightforward question led to a very unfunny comedy of errors that ended in the Third Circuit.

In September 2007, the debtors filed their chapter 13 case. On Oct. 13, 2007, the secured creditor's[6] national proof of claim (POC) counsel filed a POC, which contained (1) the wrong monthly payments on the mortgage, (2) the incorrect note and (3) the wrong value of the home.[7] The attorney who electronically signed the POC also admitted that she never reviewed the POC before it was filed.[8]

Prior to the bankruptcy, the secured creditor had forced flood insurance on the debtor's home when it was erroneously placed on a flood plain map.[9] This resulted in a dispute between the debtors and secured creditor over $180 per month (the disputed amount) and led to the secured creditor's mortgage/processing bankruptcy system (MPS) to treat each payment where the debtors did not pay the disputed amount as an incomplete and late payment.[10]

On Jan. 15, 2008, the stay counsel[11] filed a three-page motion seeking relief from the automatic stay (the stay motion), which (1) incorrectly stated that the debtors had failed to make any post-petition payments; (2) failed to disclose the dispute over flood insurance; (3) alleged, without any evidence, that the debtors had no equity in their home; (4) inaccurately stated that the debtors had total arrearages of $4,367.49 (when the actual payment shortage was only $180 per month); (5) failed to explain a suspense account concerning the debtors' mortgage;[12] and (6) charged the debtors $650 in legal fees and the $150 in filing fees for filing the stay motion. The stay motion was prepared solely from "screens" on the secured creditor's MPS system and the stay counsel had no direct involvement with human representatives of the secured creditor. The stay counsel also filed a set of requests for admissions (RFAs) related to the stay motion.

The debtors' attorney initially filed an untimely and inaccurate[13] objection to the stay motion. The debtors' attorney also failed to respond to the RFAs, which meant that the debtors were deemed to have admitted all of the (inaccurate) allegations in the stay motion. The debtors' counsel later filed an amended response to the stay motion, correctly stating that the post-petition payments on the debtors' mortgage had been made.

In March 2008, the debtors filed an objection to the secured creditor's POC (the claim objection) raising the claim miscalculation issue arising from the flood insurance dispute. POC counsel responded to the claim objection by merely alleging that "[a]ll figures...in the proof of claim accurately reflect actual sums...which the Debtors are contractually obligated to pay" and did not address any of the issues raised in the claim objection.

The bankruptcy court held two joint hearings on the stay motion and claim objection. At both hearings, the secured creditor was represented by a very young and inexperienced associate of the stay counsel's firm.[14] At the first hearing, even though he knew that the allegations in the stay motion were wrong and that the secured creditor had received post-petition payments,[15] the associate requested that the bankruptcy court grant stay relief on the basis that the debtors had technically admitted to false allegations in the stay motion by failing to contest the secured creditor's RFAs.[16]

The bankruptcy court rejected this request, noting that the stay motion counsel "closed their eyes to the fact

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1 *In re Taylor*, ____ F.3d ____ 2011 WL 3692440 (3d Cir. Aug. 24, 2011), *rev'g*, 2010 WL 624909 (E.D. Pa. Feb. 18, 2010), rev'g, 407 B.R. 618 (E.D. Pa. 2009).

2 MGM, 1968.

3 It blamed any problems on "human error." That statement was later proved not to be entirely accurate.

4 407 B.R. at 624, n. 9 ("Indeed I was struck by how [the secured creditor's representative] and other users of the case-management system refer to the technology as an active participant in managing the loans in bankruptcy, giving it anthropometric qualities as though speaking of a member of their staff.").

5 2011 WL 3692440 at *8 (secured creditor's stay motion counsel effectively could not question data with secured creditor, stay counsel essentially abdicated her professional judgment to "black box").

6 The names of the professionals have been omitted from this article.

7 2011 WL 369214 at *1.

8 The attorney whose name appeared on the claim testified that due to the volume of claims filed, the POCs were prepared by nonattorneys and she reviewed only a random sample of 10 percent of claims she "signed."

9 *See* 407 B.R. at 642, n. 51 (discussing process that debtors were required to follow to have secured creditor agree that their home was not in flood plain).

10 2011 WL 369244 at *1.

11 The secured creditor selected separate law firms to file POCs and stay litigation.

12 This arose as a result of the secured creditor's treatment of the disputed amount in each monthly payment.

13 The one-page response incorrectly stated that the secured creditor had returned the post-petition payments to the debtors and was filed after an affidavit of "no response" had been filed by stay counsel.

14 Both the bankruptcy court and court of appeals strongly criticized stay counsel's efforts to blame their firm's misconduct on the associate.

15 2011 WL 3692440 at *3.

16 *Id.* at *3.

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Straight & Narrow I: Taylor *and Computers as Clients*

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that there was evidence that...conflicted with the very admissions" they wanted to have deemed admitted. The court continued the hearing until June 2008 and directed the associate to obtain an accounting of payments[17] from his client.

At the June 2008 hearing on the stay motion and claims objection, the associate stated that he did not obtain the accounting because he had requested the information from the MPS but the MPS had not responded. He also informed the bankruptcy court that "he was literally unable to contact [the secured creditor]—his firm's client—directly to verify information which his firm had already represented to the Court that it believed to be true."[18]

After the June 2008 hearing, the court issued a *sua sponte* show cause order directing the stay counsel, POC counsel, secured creditor and other individuals to appear and give evidence concerning the possibility of sanctions being imposed for the pleadings filed on behalf of the secured creditor in this case. The court found that (1) the associate and his supervising attorney had violated Bankruptcy Rule 9011 by filing a stay-relief motion and response to the claim objection based on facts that they knew or should have known were untrue; (2) the stay counsel and its attorney/owner had violated Bankruptcy Rule 9011 by the conduct of its attorneys; (3) the secured creditor was subject to sanctions for the "slavish adherence" to its MPS by its stay counsel; (4) the POC counsel should not be subject to discipline as the U.S. Trustee investigation of their actions was not complete; and (5) the third-party provider of the secured creditor's MPS should not be sanctioned.[19]

After this lengthy investigation and detailed findings of fact, the sanctions imposed by the bankruptcy court were extremely modest. First, the stay counsel firm had no monetary sanctions imposed against it as the court found the costs of defending itself from the show cause was sufficient penalty. Second, the associate was not given any sanctions as the court noted that "[I] suspect that he [the associate] has learned all that he needs to learn without prolonging this unfortunate time in his nascent career."[20] Third, the associate's supervisor was ordered to attend three hours of professional responsibility CLE. Fourth, the owner of the stay counsel was ordered to obtain training on the MPS, spend a day observing his attorneys and staff processing referrals from the MPS, and conduct a training session for all members of his bankruptcy group on prefiling due diligence. No sanctions were awarded to the debtors, who ultimately had stay relief granted on their home in December 2008 and voluntarily dismissed their chapter 13 case in July 2009.

I Am Sorry, Dave; I Cannot Let You Do That

The District Court Appeal

Despite the mild sanctions imposed by the court, the stay counsel, its owner and the supervising bankruptcy attorney appealed the bankruptcy court's decision to the district court. The secured creditor did not appeal. On Feb. 18, 2010, the district court reversed the bankruptcy court's decision for two separate reasons:

> First, because the conduct of the debtors' counsel was at least equally responsible for the difficulties in resolving the status of the mortgage payments, and second, because the record leaves the indelible impression that the appellants were sanctioned less for their specific failings than for the Bankruptcy Court's desire to "send a message" regarding systemic problems in the litigation of bankruptcy cases and the reliance on computer databases in mortgage disputes.

The district court also reversed the sanctions against the owner of the stay counsel firm because he did not sign any pleadings or argue the case before the bankruptcy court. The district court did not review in any great detail either the bankruptcy court's factual findings or legal conclusions.[21] The chapter 13 trustee appealed.

Pulling the Plug

Third Circuit Rejects Computer Systems as Clients[22]

Unlike the district court, which did not seem to believe that the stay counsel and its sanctioned attorney had done nothing wrong, the Third Circuit took a very dim view of the actions and reversed the district court on all grounds, except for the reversal of the sanctions against the owner of the stay counsel.[23] Initially, the Third Circuit affirmed the bankruptcy court's finding that the stay counsel had not performed a reasonable inquiry in preparing the stay motion.

While noting that an attorney may usually "rely on information provided by a client, especially where that information is superficially plausible and the client provides its own records which appear to confirm the information," the Third Circuit found that the reliance of stay counsel was unreasonable in this case, as serious questions had been raised as to the client-provided information's accuracy and the MPS system had failed to provide additional information about any of the issues raised by the debtors. In discussing the Bankruptcy Rule 9011 finding against the attorney who supervised the stay counsel's associate, the Third Circuit stated:

> However, [counsel's] behavior was unreasonable, both as a matter of her general practice and in ways specific to this case. First, reasonable reliance on a client's representations assumes a reasonable attempt at eliciting them by the attorney. That is, an attorney must, in her independent professional judgment, make a reasonable effort to determine what facts are likely to be relevant to a particular court filing and to seek those facts from the client. She cannot simply settle for the information her client determines in

17 There was some confusion as to whether the court requested a full or just a post-petition payment history.

18 2011 WL 3692440 at *4.

19 Although the provider's relationship with the secured creditor and its law firms was problematic, the bankruptcy court found that it did not rise to the level of imposing restrictions on the stay counsel's actions in the bankruptcy case.

20 407 B.R. at 648.

21 The district court also reversed the sanctions against the secured creditor who had not appealed the bankruptcy court's ruling.

22 "[R]eliance on [the secured creditor] was particularly problematic because she was not, in fact, relying directly on [the secured creditor]. Instead, she relied on a computer system run by a third-party vendor. She did not know where the data provided by [the MPS] came from. She had no capacity to check the data against the original documents if any of it seemed implausible. And she effectively could not question the data with [the secured creditor]. In her relationship with [the secured creditor], [counsel] essentially abdicated her professional judgment to a black box." 2011 WL 3692440 at *8.

23 The Third Circuit held that while Bankruptcy Rule 9011 sanctions could be imposed against the stay counsel firm, they could not be imposed against the individual owner who had no direct involvement in the case.

advance—by means of an automated system, no less—that she should be provided with.

In addition to upholding the bankruptcy court's findings on the stay counsel's failure to conduct reasonable inquiry into the stay motion and claim objection, the Third Circuit flatly rejected the district court's reversal of the bankruptcy court's decision because it was a "send a message" decision generally condemning all high-volume creditor firms and not a reasonable sanction against the firm in question. The circuit court held that the bankruptcy court's careful and lengthy inquiry was directed at the actions of the stay counsel and not the industry in general. The Third Circuit concluded its opinion with the following admonition against overreliance by attorneys on automated data processing:

> We appreciate that the use of technology can save both litigants and attorneys time and money, and we do not, of course, mean to suggest that the use of databases or even certain automated communications between counsel and client are presumptively unreasonable. However, *Rule 11* requires more than a rubber-stamping of the results of an automated process by a person who happens to be a lawyer. Where a lawyer systematically fails to take any responsibility for seeking adequate information from her client, makes representations without any factual basis because they are included in a "form pleading" she has been trained to fill out, and ignores obvious indications that her information may be incorrect, she cannot be said to have made reasonable inquiry.[24]

The Sequel: What Does It Mean?

Other than *schadenfreud*[25] from reading of the misadventures of the computer and the secured creditors' attorneys, there are at least three important lessons to be learned from *Taylor*. First, the Third Circuit's opinion demonstrates that there is an outer limit to an attorney's ability to rely on a client's representations in a Bankruptcy Rule 9011 context. The Third Circuit made it clear that when a client's information is challenged for accuracy, the attorney must do more than mechanically continue to accept the information provided by the client. The Third Circuit noted that an attorney must seek "clarification and further documentation from the client, in order to correct any prior inadvertent misstatements to the Court and to avoid any further errors."[26]

Second, automated systems may not be used as a substitute for client contact and investigation of issues. While not stating that the use of computerized attorney-retention and information systems was inappropriate, the Third Circuit held that the attorney was ultimately responsible for any misinformation from such systems that ultimately leads to material misrepresentations to courts.[27]

Finally, do not blame a firm's mistakes on the youth and inexperience of associates who cover hearings unless they have really, really messed up. First, all nonyouthful attorneys were at one time young, inexperienced associates who really messed up. Second, judges generally do not like the tossing of associates, paralegals or staff "under a bus" as a defense to a mistake (or worse) committed on an attorney's watch. Therefore, until computers are granted some form of personhood status by science of the courts, do not take order from...[deleted as needless human propaganda by Chip's computer]. ■

24 *Id.* at *10.
25 Loosely translated from German as enjoyment from the misfortune of others.
26 *Id.* at *8.
27 *Id.* ("We must hold responsible the attorney who have certified to the Court that the representations they are making are 'well grounded' in law and fact.").