AMERICAN BANKRUPTCY INSTITUTE

2017 Bankruptcy Battleground West

Ethics: Who's Your Daddy? Acing Your Fiduciary Duties

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2017

The Ethical Responsibilities of Counsel to the Debtor-in-Possession as a Three-Layer Cake

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January 2017

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I. The Bottom, Solid, Layer: Counsel's Duty to the Client and Tribunal, Generally

a. Regardless of the fact that an attorney is representing a debtor-in-possession and appearing in bankruptcy court and operating under the Bankruptcy Code and Rules and the like, under the Model Rules of Professional Conduct, all attorneys—bankruptcy and nonbankruptcy attorneys both—owe their clients the fiduciary duties of *loyalty* and *care*.[1]

i. Loyalty

1. Maintain client confidentiality; and

2. Prevent any conflict of interest.

ii. Care

1. Abide by the client's decisions regarding legal objectives;

2. Act with reasonable diligence;

3. Zealously represent the client;

4. Keep the client reasonably informed regarding the representation;

5. Exercise independent judgment; and

6. Render candid advice;

b. Counsel's duty to the tribunal as an officer of the court.

i. Additionally, as officers of the court, all attorneys owe a duty of candor to the tribunal.[2]

1. This duty precludes counsel from:

a. Making false statements of law or fact to the court;

b. Offering false evidence;

2. And requires counsel to:

[1] *See* Model Rules of Professional Conduct Rules 1.1, 1.2, 1.3, 1.4, 1.6, 1.7, 1.8, 1.9, 1.10 and 2.1. Note that states use their own rules and that federal courts sometimes use the model rules of the states in which the sit while others use the Model Rules.

[2] Model Rules of Professional Conduct Rule 3.3.

a. Disclose controlling adverse legal authority that is not disclosed by opposing counsel; and

b. Disclose facts necessary to avoid assisting the client in a criminal or fraudulent act.

II. The Second, Stable, Layer: The Bankruptcy Code and Rules Impose a Heightened Standard of Conduct on Counsel to Debtors-In-Possession, and Give Bankruptcy Courts Oversight Powers to Maintain Order

a. Avoid Conflicts of Interest; Supervise Professional Compensation

i. § 327(a) (restricting use of attorneys, accountants, appraisers, auctioneers, or other professional persons to individuals who do not hold interests adverse to estate). *See In re Project Orange Associates LLC*, 431 B.R. 363, 370 (Bankr. S.D.N.Y. 2010) ("Generally stated, the adverse interest test is objective and excludes any interest or relationship, however slight, that would even faintly color the independence and impartial attitude required by the Code and the Bankrupty Rules.")

1. Case law defines "adverse interest" as follows: (i) to possess or assert any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant, or (2) to possess a predisposition under circumstances that render such a bias against the estate. *JMK Constr. Group, Ltd.*, 441 B.R. 222, 229 (Bankr. S.D.N.Y. 2010) (citing *In re AroChem Corp.*, 176 F.3d 610, 623 (2d Cir. 1999)).

2. Piecemeal disclosures are a recipe for disaster, even if there is no other basis (such as lack of disinterestedness or actual conflict of interest) to disqualify counsel or deny fees. They evidence a who-cares attitude on the part of counsel. Disclosures should not be scattered among multiple filings or hidden by verbiage.

a. It is not sufficient that connections are disclosed in other pleadings, such as in a Statement of Financial Affairs or at a 341 meeting. *In re Gluth Bros. Constr., Inc*., 459 B.R. 351, 362 (Bankr.N.D. Ill. 2011).

b. The court and parties in interest are not required to scour the record to sleuth out disclosures.

c. The Official Forms should be used and employment applications and accompanying verifications should comply with Rule 2014.

ii. § 328 (giving the court the power to decrease agreed upon compensation or deny compensations and reimbursements if the professional is not disinterested or holds an interest adverse to the state on the matter on which he is employed—which serves as a penalty for conflicts of interest).

iii. § 329 (requiring attorneys to submit specific statements of the compensation paid or agreed to be paid during the year prior to the commencement of the bankruptcy case for services rendered or to be rendered in contemplation or in connection with the case, which allows the court to determine whether the fees are reasonable).

iv. § 330 (providing authority to award reasonable fees and expenses to professionals and setting specific factors to be used in determining whether fees and expenses are reasonable).

v. Rule 9011 and the inherent authority of bankruptcy courts. *See In re Count Liberty, LLC*, 370 B.R. 259, 271 (Bankr. C.D. Cal. 2007) (discussing the avenues available to bankruptcy courts to sanction bad conduct).

1. Pleadings, motions, or other submissions must be made for a proper purpose;

2. Legal contentions must be warranted by existing law or based on a nonfrivolous argument for its extension;

3. Factual contentions must have evidentiary support.

vi. Failure to disclose carries serious consequences, including disqualification, reduction or denial of fees or disgorgement of fees, and potential loss of reputation with the court.

1. Note that failure of counsel to identify connections and conflicts that are known within the firm but that are not discovered due to a poor conflicts check system is gross negligence. *In re Ellipso*, *Inc*. 462 B.R. 241, 251 (Bankr. D.D.C. 2011).

b. Obey Disclosure Requirements

i. Rule 2014 (requiring retention application to state "to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.").

ii. Rule 2016 (b) (compelling disclosure of compensation paid or promised to bankruptcy petition preparer).

III. The Shaky, Messy, Top: Duties That Belong to the Debtor in Possession Itself Imputed to DIP Counsel

a. Under Section 1107(a), the DIP is a de facto trustee. *See Count Liberty,* 370 B.R. at 275 (discussing the responsibilities of a DIP).

i. But note that the DIP has inborn conflicts of interest due to, among other things, the survival instinct and desire to preserve jobs;

1. The debtor-creditor relationship is inherently adversarial;

2. The process of selecting which executory contracts to accept, assign, or reject requires decisions about and between creditors;

3. The selection of enterprise value puts certain classes of creditors and equity holders into or out of the money;

4. Plan development and confirmation requires decisions about and among classes of creditors and equity holders.

b. Additionally, the DIP must adhere to the requirements of the Bankruptcy Code and Rules regarding:

i. Nonpayment of prepetition debt;

ii. Restrictions on the use of cash collateral;

iii. Procedures for the assumption or rejection of executory contracts;

iv. Prior approval of out-of-course transactions;

v. Timely payment of administrative claims;

vi. Accurate reporting;

vii. The restriction on solicitation of acceptances of the reorganization plan;

viii. Compliance with the absolute priority rule

c. To whom does the DIP owe its fiduciary duty?

i. An insolvent DIP has a fiduciary obligation to creditors. *See Second Nat'l Bank of Nazareth v. Marcincin (In re Nadler)*, 8 B.R. 330, 333

(Bankr. E.D. Pa. 1980); *Ford Motor Credit Co. v. Weaver*, 680 F.2d 451, 460-61 (6th Cir. 1982).

ii. DIPs are like officers of the court, who have a fiduciary duty to act in the best interests of the estate. See, e.g., *In re Intermagnetics Am., Inc.*, 926 F.2d 912, 917 (9th Cir. 1991) (noting chapter 11 debtors occupy fiduciary role with respect to estate); *Continental Ill. Nat'l Bank & Trust Co. v. Wooten (In re Evangeline Refining Co.)*, 890 F.2d 1312, 1322-23 (5th Cir. 1989) (discussing concept of officers of the court).

d. The DIP's Duties Imputed to the DIP Counsel

i. Are there conflicting duties imposed on the counsel to the DIP based on the attorney's role as spirit guide to the novice DIP?

1. An attorney for the DIP cannot simply close his or her eyes to matters having adverse legal and practical consequences for the estate and creditors. *Grubin v. Rattet (In re Food Mgmt. Group),* 380 B.R. 677, 708-10 (Bankr. S.D.N.Y. 2008) (attorney-defendants who did not bring a close relationship between the existing debtor's principals and the stalking horse bidders owed a fiduciary duty to the Court and all of the Debtor's constituencies to speak truthfully, and to correct any misstatements or material omissions they subsequently discovered); *County Liberty*, 370 B.R at 82-83 (Counsel to the DIP "failed to act diligently to ensure that [debtor's] principal took appropriate steps to safeguard the funds.").

2. The attorney for the DIP has a duty to counsel the DIP to comply with the DIP's duties and obligations under the law. *Food Mgmt. Group*, 380 B.R. at 709.

a. Because the DIP is a fiduciary, it must be even-handed despite its inherently conflicted position as de facto, trustee. But on the other hand, the DIP must also advocate for its own selfish position. *Id.*

ii. DIP counsel must be proactive, which means counsel must be prepared to render unsolicited legal advice regarding preventive or corrective action that may be necessary for the DIP to properly discharge its fiduciary obligations. *Count Liberty*, 370 B.R. at 281.

iii. Because DIP counsel must keep the DIP in line, there is a heightened duty of care for DIP counsel to remain disinterested because the DIP is not. This means DIP counsel must be free of adverse entanglements that might cloud its judgment. *Food Mgmt. Group*, 380 B.R. at 709.

iv. DIP counsel cannot advocate for the principals at the expense of the estate. *Court Liberty*, 370 B.R. at 282.

v. Does the DIP counsel's role as an officer of the court create its own set of conflicting duties?

1. An attorney's knowledge or sponsorship of misdeeds by his or her clients, including a client's nondisclosure of material information when appearing before the court, may be grounds for alleging fraud on the court against the attorney. *Food Mgmt. Group*, 380 B.R. at 715.

2. The Model Rules and state ethic rules are based on a traditional advocacy model, which involves two parties who are in court on a limited basis and for limited reasons. But chapter 11 involves multiple players with issue-specific alliances. The DIP visits bankruptcy-land, and its entire existence is highly regulated for the duration of its stay; DIP counsel is the DIP's guide during its time in bankruptcy-land. The DIP is visiting a strange new land for an extended period of time, but the DIP counsel is a permanent resident who knows the local customs and rules; the attorney must keep his or her client out of trouble during its visit.

vi. The DIP's attorney owes an allegiance to the debtor's estate—not to those running the estate. The long-term interest of the estate may conflict with the interests of DIP's managers controlling the estate.

1. DIP counsel has an obligation to dig deeper into DIP management's actions when counsel has knowledge, information and belief formed after a reasonable inquiry.

a. In *In re JLM, Inc*., 210 B.R. 19 (B.A.P. 2d Cir 1997), a secured creditor became the owner of the DIP during a chapter 11 case. DIP's counsel declined to follow instructions of the new owner to dismiss the chapter 11 case, and DIP counsel actively opposed motions filed by the same secured creditor (qua creditor) to lift the stay or dismiss the case. Counsel believed the secured creditor wanted to dismiss the bankruptcy case because the secured creditor's financing statement had lapsed and it wanted protection form a potential avoidance action. Counsel also believed dismissal was not in the best interest of creditors. The secured creditor opposed DIP counsel's request for compensation on the ground that counsel was really protecting the interests of the deposed former owners. The bankruptcy court

disallowed counsel's fees, but the BAP reversed and remanded, finding that the DIP counsel had a higher duty to the estate than to the DIP's new owners; the BAP found that the DIP counsel's actions likely benefited the estate.

vii. There is a duty to rat, but its triggered only if the following steps don't work:

1. Explain the DIP's fiduciary duties;

2. Cajole;

3. Threaten;

4. Go up the chain of command within the client entity.

viii. But can counsel's actions really be characterized as ratting on the client (or breaching client confidentiality) when the ultimate client is the Bankruptcy Court, or the nebulous estate, or even the integrity of the bankruptcy system itself?

1. No. Counsel is not ratting on its client. Rather, counsel is ratting on the agents of the DIP/client that have failed or refused to recognize the fiduciary obligations that the DIP undertook when the DIP was granted the right to remain in possession of the estate.

    a. But that's easier for the attorney to understand than the client's agents. Does the existence of the duty to rat drive a wedge between the DIP counsel and the DIP client?

2. Some courts hold that DIP counsel has a duty not merely to advise but also to police the DIP; quiet acquiescence will not do. *See In re Sky Valley, Inc.* (Bankr. N.D. GA 1992) (DIP counsel must be proactive and not turn a blind eye to actions or motions that would violate the Bankruptcy Code or Rules).

ix. Although DIP counsel's duties do not run to particular creditors, some courts have held that the duty extends to creditors generally. *ICM Notes, Ltd. v. Andrews & Kurth L.L.P.*, 278 B.R. 117, 123 (S.D. Tex. 2002) (no duty to individual creditors).

x. Courts are conflicted about whether DIP counsel owes a duty to the bankruptcy estate or to the DIP. Judge Kozinski, in *In re Perez*, 30 F.3d 1209, 1219 (9th Cir. 1994), writing for the Ninth Circuit in an opinion that is otherwise a model of clarity and thoughtful judicial

analysis, makes inconsistent statements regarding the DIP counsel's client just a few words apart:

> "Counsel for the estate must keep firmly in mind that *his client is the estate* and not the debtor individually. Counsel has an independent responsibility to determine whether a proposed course of action is likely to benefit the estate or will merely cause delay or produce some other procedural advantage to the debtor. While he must always take his directions from his client, where counsel for the estate develops material doubts about whether a proposed course of action in fact serves the estate's interests*, he must seek to persuade his client to take a different course or, failing that, resign*. Under no circumstances, however, may the lawyer for a bankruptcy estate pursue a course of action, unless he has determined in good faith and as an exercise of his professional judgment that the course complies with the Bankruptcy Code and serves the best interests of the estate."

The client is either the estate or the guy (Kozinski calls him "the client," aka the DIP) whom he's admonished to persuade to take a different course of action. Not both. Remember, the estate is a bundle of property interests and rights—it's not a sentient being that can be consulted and conversed with.

xi. Despite the confusion and the potentially dangerous consequences for counsel, many cases hold that the estate is the DIP counsel's client. *See Food Mgmt. Group*, 380 B.R. at 707; *Count Liberty*, 370 B.R. at 280.

1. But can the estate *be* the client?

    a. Does the "estate as client" approach turn DIP counsel into the Oracle at Delphi?

    b. Does the "estate as client" approach turn DIP counsel into his or her own client?

    c. Can DIP counsel do whatever he or she thinks is in the best interests of the estate, regardless of what the DIP wants to do?

2. What exactly is the estate, anyway?

    a. Interests of the creditors and the equity holders;

    b. Interests of creditors and shareholders, if solvent.

xii. *Hansen, Jones & Leta, P.C. v. Segal*, 220 B.R. 434, 453 (D. Utah 1998) is the key case that suggests imputing the DIP's fiduciary duty to its counsel (i.e., giving counsel its own set of fiduciary duties to the estate or to creditors rather than to counsel's client, the DIP) is unnecessary and unnecessarily confusing.

1. ""Imposing an undefined fiduciary duty to the estate and its beneficiaries on counsel for debtor-in-possession is confusing, unhelpful and unnecessary to insure that counsel is independent and aware of his/her duty under the Bankruptcy Code and Model Rules to represent and assist the debtor-in-possession in the performance of its duties. . . . In virtually all the cases which rely on counsel's fiduciary duty to the estate in sanctioning counsel, the same result would be reached by finding a breach of counsel's fiduciary duty to the client debtor-in-possession, violations of Sections 327, 328, or 329, and/or failure to provide services which benefit the estate under Section 330."