# Silence Is Not Golden: Disclosure Issues in Consumer Cases

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# THE SCENARIOS

1. Debtor hires attorney Smith to file a chapter 7 case. He pays the $1,500 fee up front, plus filing fee and other costs. Attorney Smith executes a retainer agreement with the Debtor that clearly identifies the fee as a "flat fee," "earned upon receipt," and "non-refundable." Attorney Smith spends 2 hours with the client and reviewing documents. His paralegal spends another 2 hours working on the file. Three months after signing the retainer agreement, the Debtor visits with his regular attorney, Ms. Jones. Ms. Jones devotes a portion of her practice to bankruptcy work, but Debtor owed attorney Jones $800, and was afraid to visit with her about bankruptcy initially. However, Debtor has a change of heart. He pays Ms. Jones' $800 outstanding fee, and pays another $1,500 to Jones to file his chapter 7 case. Debtor requests that Smith refund his retainer fees. Smith, pointing to the retainer agreement, returns the filing fee and costs to the Debtor, but declines to refund the attorney fee. Debtor files the chapter 7 case with Jones, disclosing on the SOFA (in all caps, boldface type) that he had paid Smith $1,500 for bankruptcy services within a year of filing, and did not receive a dime's worth of benefit for his trouble. The $1,500 payment to Ms. Jones is also reflected on the SOFA as a bankruptcy payment within one year, but nothing is disclosed concerning the $800 payment to Ms. Jones.

2. During the initial bankruptcy consultation, Debtor mentioned to Mr. Smith that he had a side business involving the distribution of illegal narcotics. However, the money was all "tax-free" because he received payment in cash. Mr. Smith had advised the Debtor that this activity would have to be disclosed in bankruptcy. The Debtor did not disclose the drug trafficking or the additional income to Ms. Jones. Ms. Jones noticed during the preparation of the schedules that Schedules I and J reflected a deficiency of $1,200/mo., which was odd given that the Debtor was current on his payments for his house, two cars, Harley Davidson motorcycle, and pontoon boat. But since that was pretty much par for the course for debtors (why else would they be here?), she did not inquire further. When Ms. Jones filed the case, Mr. Smith, who was highly suspicious as to why the Debtor had elected not to file with him, reviewed the schedules on PACER and was astonished to see nothing about the drug trafficking business. Having scored a 100% on the MPRE, Mr. Jones did not want to mess around with his duty of candor towards the tribunal. He promptly used his secret email account to send the trustee a message about the Debtor, saying, "There's more income--better look closely!" During the 341 meeting, the trustee asked the Debtor about any other sources of income, including cash receipts. The Debtor responded that he didn't want to get into any trouble as this isn't the sort of thing "you put on the books." The trustee assured the Debtor that honesty is the best policy and the trustee had no intention of penalizing the debtor for being truthful. The Debtor proceeds to tell the whole story as Ms. Jones sits by, mouth agape in shock.

3. After the 341 meeting, Ms. Jones begins to lecture the Debtor about the seriousness of his predicament. She also reminds him that the attorney's fees for what is about to come are NOT covered by the initial retainer agreement. The Debtor proudly tells her that this won't be a problem because "the trustee still doesn't know about the little nest egg" that he set up with the drug money to deal with these sorts of emergencies. While Ms. Jones is demoralized at this latest revelation, even telling her client that he should come clean, when the Debtor tells her that he has no intent to do so, she tells him that she will need another $3,500 retainer to work on an hourly basis to deal with the various discharge and dismissal issues that may come up. She also is adamant that the funds come from the Debtor's bank account, not his "nest egg." Although the additional fee was not disclosed on the Disclosure of Compensation, her retainer agreement clearly specified that this additional retainer would be required in the event of any "contested" matters. The Debtor pays the retainer fee out of his wage income, indicating that he will just pay for his living expenses from the nest egg. Bound by her duties of confidentiality, Ms. Jones does not make any disclosures concerning these issues.

4. During the coming months, Ms. Jones responds to a non-dischargeability complaint filed by the trustee, and also attends a 2004 examination called by the US Trustee. After Jones has billed $2,500 against the additional retainer, the Debtor contacts his vehicle lender regarding a reaffirmation agreement. Having had an excellent relationship with the Debtor, the lender negotiates the agreement directly with the Debtor. The lender consults with its attorney, informing her that this loan was dramatically undersecured. The attorney suggested that the lender should entice the Debtor with a lower interest rate and longer term, especially since the court might not approve the reaffirmation without some sort of concession. The lender's attorney ultimately files the signed agreement (not endorsed by Ms. Jones, who withheld her consent). The agreement indicates that the value of the vehicle was the same as the loan balance, because that is how the Debtor has scheduled it. The Court sets a hearing on the agreement. Ms. Jones reminds the Debtor that her appearance at the hearing would be charged against the remaining $1,000 in the trust account. The Debtor, having "bigger fish to fry," instructs Jones not to attend the hearing, and indicates that he will attend the hearing on his own. The Debtor has the right to decide the scope of the representation, so Ms. Jones complies. During the hearing, the court inquires of the debtor as to how he can pay the mortgage with a $1,200 deficiency in his budget. The Debtor curtly informs the court that his attorney made an error, and he actually has more income than that. The court, unimpressed with the explanation, denies the reaffirmation agreement. Worried about losing his car, his nest egg, and his discharge, the Debtor instructs Jones to use the last $1,000 to convert the case to chapter 13. Ms. Jones does so, even filing an amended disclosure of compensation with the conversion indicating that she received an additional $1,000 for the conversion.

5. Upon the conversion of the chapter 13 case, Ms. Jones (seeking to avoid further interference by the UST and the trustee) files a chapter 13 plan that proposes to pay all timely filed, allowed claims in full. She files an amended Schedule I and J that shows sufficient income to fund the plan due to a newly disclosed "delivery service" side business that the debtor runs as a sole proprietor. In the chapter 13 plan, Jones proposes that the student loan claim of NSL will not receive interest through the plan, and further states that any claim for interest will be discharged upon entry of the discharge. The attorney for NSL actually noticed this provision in the plan, and recommended to his client that they object to the plan. However, NSL noticed that the Debtor has schedule the NSL claim as $60,000, and did not list the debt as unliquidated, disputed, or contingent, despite the fact that NSL was actually owed only $38,000. NSL has no knowledge of why the Debtor listed the higher balance, but suggests to its attorney simply file a claim for $60,000 (attaching the original loan documents, which show that the original loan was for $80,000). Additionally, rather than "poke the bear" NSL requests that the attorney not object to the chapter 13 plan, as they will recover much more than the actual balance on the claim by "leaving well enough alone." The attorney, not knowing the background of the claim balance, reviews the schedules of the debtor, knows that judicial estoppel will bar the debtor from objecting to the claim, and files it as is. NSL also has a second claim for $2,000 on account of a payday advance that had been made to the Debtor over eight years prior to the bankruptcy case. The Debtor had never made a single payment on the debt, and NSL had written it off. NSL requests that their attorney file the claim. However, to avoid any unnecessary arguments about statute of limitations periods, NSL again requests that no documents be attached to the claim. The attorney, recognizing that the statute of limitations is an affirmative defense, and knowing that the original documents have long been lost, files the claim with a notation stating "documents destroyed when claim was written off."

6. Lucy and Ricky Recardo file for chapter 7 relief in the Western District of Missouri. The home is encumbered by a deed of trust in the amount of $150,000.00. The debtors have scheduled the value of the property at $160,000.00. The Statement of Intention provides for the surrender of the property to the secured lender. A local law firm , Smith & Smith, files a motion for relief from the automatic stay alleging that the lien of its client is properly perfected and that no equity exists for the benefit of the debtors or the bankruptcy estate . Following his review of the note and deed of trust attached as exhibits to the motion , the trustee elected to not respond to the motion for relief because insufficient equity existed to administer. Thereafter, the debtors received their discharge and the case was closed . Several months later the debtors received a letter from a law firm , Jones & Jones, claiming to represent the secured lender on their home and informing the debtors that the legal description in the deed of trust was incorrect (actually describing a different property). Demand was made for the debtors to execute a modification document before a notary. They were directed return the signed document within 10 days to avoid the filing of a lawsuit in which they would be named defendants to reform the deed of trust. The letter was thereafter provided to the former case trustee who contacted Smith & Smith. The attorney at Smith & Smith informed the trustee that he could not discuss the letter because her firm no longer represented the secured lender, who was now being represented by counsel retained by the title company that had originally insured title .

7. Larry Lawyer gets a call from Debbie Debtor who says she is in dire need of filing bankruptcy to save her car which she suspects will be repossessed any day and says she had been referred to him by one of his former clients. Unfortunately, Debbie cannot remember the name of the person who referred her. Nonetheless, Larry says she should come into his office that day or maybe in the morning to sign the petition and get the case filed. Debbie, however, said she had to work every day for the next two weeks and will lose her job if she misses another day of work. She will have to miss work if she has to come in to see Larry during that time or if she loses her car. So, Larry takes down Debbie's personal information for the petition as well as the name and address of the lender on Debbie's car. He tells her he will file a Chapter 13 "quick file" petition for her and that he needs to meet her soon in order to file her bankruptcy schedules and statements and her plan. Larry files the petition and discloses electronically in it that Debbie has signed the petition before it was filed.

Two weeks later, Larry gets a copy of a show cause order in the case from the Honorable Jerry Judge requiring Larry and Debbie to appear in Court and show cause why the case should not be dismissed. Larry shows up to Court but the "Debbie" he spoke to on the phone does not. Judge Jerry explains to Larry that someone named Debbie Debtor contacted the Court to say she learned a Chapter 13 bankruptcy petition was filed in her name but that she had not authorized such a filing. In fact, she says that Carrie CarBuyer who was buying the car directly from her while it remained in her name was behind on the payments to the lender and is the one who contacted Larry about filing the bankruptcy case.

8. Larry Lawyer gets a call from Danny Debtor who says he thinks he needs to file bankruptcy. After learning his lesson in the "Debbie Debtor" case, Larry makes an appointment to meet Danny Debtor at his office, in person, after asking Danny to bring in a list of his assets and debts and the latest copies of his bills. When Danny arrives, Larry's paralegal Paulie meets with Danny and instructs him to complete a written questionnaire which includes substantial detail about his financial condition before meeting with Larry. In the questionnaire, Danny discloses that he has horse equipment including two western saddles and tack but does not specifically disclose that he owns horses. In addition, he indicates that he had a joint bank account with his mother. Danny had filed a chapter 7 proceeding and received a discharge five years earlier but did not check the box on the questionnaire about a prior filing.

Larry meets with Danny and goes over the questionnaire with him in order to properly complete his bankruptcy schedules and statements. He included the horse equipment on Schedule B but did not ask Danny whether he owned a horse so he didn't list one on Schedule B. Danny told him that he had his name on his mother's bank account for convenience only and that none of the money in it was really his. Larry advised Danny to have his name removed from the account and said they would delay filing the bankruptcy until the transfer was complete. Larry said, "Since it isn't really your money, you don't have to list it." In fact, Larry did not list the transfer of the account on Question 20 of the SOFA or anywhere else in the schedules and statements. Larry did not ask Danny about a prior bankruptcy filing and did not list one on the petition.

The case was filed after the bank account was changed and Terry Trustee asked about a bankruptcy case (the US Trustee told him) that Danny had previously filed but did not list. Danny admitted he had filed it five years earlier and received a discharge. Terry asked whether Danny had a horse since he listed horse equipment. Danny said he owned two horses but Larry hadn't asked about horses. Terry asked if Danny had closed a bank account within the last year and he said he had his name removed from his mother's bank account at Larry's direction. Terry called the US Trustee.

## RELEVANT RULES

**UNITED STATES DISTRICT COURT**
**FOR THE WESTERN DISTRICT OF MISSOURI**
**LOCAL RULES**

**83.5 BAR ADMISSION**

**(c) Standards for Professional Conduct.**
1. For misconduct defined in these Rules, and for good cause shown, and after notice and opportunity to be heard, any attorney admitted to practice before this Court may be disbarred, suspended from practice before this Court, reprimanded or subjected to such other disciplinary action as the circumstances warrant.

2. Acts or omissions by an attorney admitted to practice before this Court, individually or in concert with any other person or persons, which violate the Code of Professional Responsibility adopted by this Court shall constitute misconduct and shall be grounds for discipline, whether or not the act or omission occurred in the course of an attorney-client relationship. The Code of Professional Responsibility adopted by this Court is the Code of Professional Responsibility adopted by the highest court of the state in which this Court sits, as amended from time to time by that state court, except as otherwise provided by specific Rule of this Court after consideration of comments by representatives of bar associations within the state.

**Missouri Rules of Professional Conduct**

**RULE 4-1.1: COMPETENCE**

A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

(Adopted Aug. 7, 1985, eff. Jan. 1, 1986. Amended March 1, 2007, eff. July 1, 2007)

**RULE 4-1.2: SCOPE OF REPRESENTATION**

(a) A lawyer shall abide by a client's decisions concerning the objectives of representation, subject to Rule 4-1.2(c), (f) and (g), and shall consult with the client as to the means by which they are to be pursued. A lawyer shall abide by a client's decision whether to accept an offer of settlement of a matter. In a criminal case, the lawyer shall abide by the client's decision, after

consultation with the lawyer, as to a plea to be entered, whether to waive jury trial and whether the client will testify.

(b) A lawyer's representation of a client, including representation by appointment, does not constitute an endorsement of the client's political, economic, social or moral views or activities.

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(f) A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

(g) When a lawyer knows that a client expects assistance not permitted by the Rules of Professional Conduct or other law, the lawyer shall consult with the client regarding the relevant limitations on the lawyer's conduct.

(Adopted Aug. 7, 1985, eff. Jan. 1, 1986. Amended March 1, 2007, eff. July 1, 2007; Dec. 21, 2007, eff. July 1, 2008. Amended June 23, 2008, eff. July 1, 2008.)

**RULE 4-1.4: COMMUNICATION**

**(a)** A lawyer shall:

(1) keep the client reasonably informed about the status of the matter;

(2) promptly comply with reasonable requests for information; and

(3) consult with the client about any relevant limitation on the lawyer's conduct when the lawyer knows the client expects assistance not permitted by the Rules of Professional Conduct or other law.

**(b)** A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

(Adopted Aug. 7, 1985, eff. Jan. 1, 1986. Amended March 1, 2007, eff. July 1, 2007.)

**RULE 4-1.6: CONFIDENTIALITY OF INFORMATION**

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation, or the disclosure is permitted by Rule 4-1.6(b).

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

(1) to prevent death or substantial bodily harm that is reasonably certain to occur;

(2) to secure legal advice about the lawyer's compliance with these Rules;

(3) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or

(4) to comply with other law or a court order.

*COMMENT*

[10] Other law may require that a lawyer disclose information about a client. Whether such a law supersedes Rule 4-1.6 is a question of law beyond the scope of these Rules. When disclosure of information relating to the representation appears to be required by other law, the lawyer must discuss the matter with the client to the extent required by Rule 4-1.4. If, however, the other law supersedes this Rule and requires disclosure, Rule 4-1.6(b)(4) permits the lawyer to make such disclosures as are necessary to comply with the law.

[11] A lawyer may be ordered to reveal information relating to the representation of a client by a court or by another tribunal or governmental entity claiming authority pursuant to other law to compel the disclosure. Absent informed consent of the client to do otherwise, the lawyer should assert on behalf of the client all nonfrivolous claims that the order is not authorized by other law or that the information sought is protected against disclosure by the attorney-client privilege or other applicable law. In the event of an adverse ruling, the lawyer must consult with the client about the possibility of appeal to the extent required by Rule 4-1.4. Unless review is sought, however, Rule 4-1.6(b)(4) permits the lawyer to comply with the court's order.

[12] Rule 4-1.6(b) permits disclosure only to the extent the lawyer reasonably believes the disclosure is necessary to accomplish one of the purposes specified. Where practicable, the lawyer should first seek to persuade the client to take suitable action to obviate the need for disclosure. In any case, a disclosure adverse to the client's interest should be no greater than the lawyer reasonably believes necessary to accomplish the purpose. If the disclosure will be made in connection with a judicial proceeding, the disclosure should be made in a manner that limits access to the information to the tribunal or other persons having a need to know it, and appropriate protective orders or other arrangements should be sought by the lawyer to the fullest extent practicable.

[13] Rule 4-1.6(b) permits but does not require the disclosure of information relating to a client's representation to accomplish the purposes specified in Rule 4-1.6(b)(1) to (b)(4). In

exercising the discretion conferred by this Rule 4-1.6, the lawyer may consider such factors as the nature of the lawyer's relationship with the client and with those who might be injured by the client, the lawyer's own involvement in the transaction, and factors that may extenuate the conduct in question. A lawyer's decision not to disclose as permitted by Rule 4-1.6(b) does not violate this Rule 4-1.6. Disclosure may be required, however, by other Rules. Some Rules require disclosure only if such disclosure would be permitted by Rule 4-1.6(b). See Rules 4-1.2(d), 4-4.1(b), 4-8.1, and 4-8.3. Rule 4-3.3, on the other hand, requires disclosure in some circumstances regardless of whether such disclosure is permitted by this Rule. See Rule 4-3.3(c).

**Withdrawal**

[14] If the lawyer's services will be used by the client in materially furthering a course of criminal or fraudulent conduct, the lawyer must withdraw, as stated in Rule 4-1.16(a)(1). After withdrawal, the lawyer is required to refrain from making disclosure of the client's confidences, except as otherwise permitted in this Rule 4-1.6. Neither this Rule 4-1.6 nor Rule 4-1.8(b) nor Rule 4-1.16(d) prevents the lawyer from giving notice of the fact of withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation, or the like. Where the client is an organization, the lawyer may be in doubt whether contemplated conduct will actually be carried out by the organization. Where necessary to guide conduct in connection with this Rule 4-1.6, the lawyer may make inquiry within the organization as indicated in Rule 4-1.13(b).

**RULE 4-3.3: CANDOR TOWARD THE TRIBUNAL**

(a) A lawyer shall not knowingly:

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

(2) fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel; or

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

(b) A lawyer who represents a client in an adjudicative proceeding and who knows that a person intends to engage, is engaging, or has engaged in criminal or fraudulent conduct related to the proceeding shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal.

(c) The duties stated in Rule 4-3.3(a) and (b) continue to the conclusion of the proceeding and apply even if compliance requires disclosure of information otherwise protected by Rule 4-1.6.

(d) In an ex parte proceeding, a lawyer shall inform the tribunal of all material facts known to the lawyer that will enable the tribunal to make an informed decision, whether or not the facts are adverse.

**COMMENT**

[1] Rule 4-3.3 governs the conduct of a lawyer who is representing a client in the proceedings of a tribunal. See Rule 4-1.0(m) for the definition of "tribunal." It also applies when the lawyer is representing a client in an ancillary proceeding conducted pursuant to the tribunal's adjudicative authority, such as a deposition. For example, Rule 4-3.3(a)(3) requires a lawyer to take reasonable remedial measures if the lawyer comes to know that a client who is testifying in a deposition has offered evidence that is false.

[2] Rule 4-3.3 sets forth the special duties of lawyers as officers of the court to avoid conduct that undermines the integrity of the adjudicative process. A lawyer acting as an advocate in an adjudicative proceeding has an obligation to present the client's case with persuasive force. Performance of that duty while maintaining confidences of the client, however, is qualified by the advocate's duty of candor to the tribunal. Consequently, although a lawyer in an adversary proceeding is not required to present an impartial exposition of the law or to vouch for the evidence submitted in a cause, the lawyer must not allow the tribunal to be misled by false statements of law or fact or evidence that the lawyer knows to be false.

**Representations by a Lawyer**

[3] An advocate is responsible for pleadings and other documents prepared for litigation, but is usually not required to have personal knowledge of matters asserted therein, for litigation documents ordinarily present assertions by the client, or by someone on the client's behalf, and not assertions by the lawyer. Compare Rule 4-3.1. However, an assertion purporting to be on the lawyer's own knowledge, as in an affidavit by the lawyer or in a statement in open court, may properly be made only when the lawyer knows the assertion is true or believes it to be true on the basis of a reasonably diligent inquiry. There are circumstances where failure to make a disclosure is the equivalent of an affirmative misrepresentation. The obligation prescribed in Rule 4-1.2(d) not to counsel a client to commit or assist the client in committing a fraud applies in litigation. Regarding compliance with Rule 4-1.2(d), see the Comment to Rule 4-1.2(d). See also the Comment to Rule 4-8.4(b).

**Legal Argument**

[4] Legal argument based on a knowingly false representation of law constitutes dishonesty toward the tribunal. A lawyer is not required to make a disinterested exposition of the law, but must recognize the existence of pertinent legal authorities. Furthermore, as stated in Rule 4-

3.3(a)(2), an advocate has a duty to disclose directly adverse authority in the controlling jurisdiction that has not been disclosed by the opposing party. The underlying concept is that legal argument is a discussion seeking to determine the legal premises properly applicable to the case.

**Offering Evidence**

[5] Rule 4-3.3(a)(3) requires that the lawyer refuse to offer evidence that the lawyer knows to be false, regardless of the client's wishes. This duty is premised on the lawyer's obligation as an officer of the court to prevent the trier of fact from being misled by false evidence. A lawyer does not violate Rule 4-3.3(a)(3) if the lawyer offers the evidence for the purpose of establishing its falsity.

[6] If a lawyer knows that the client intends to testify falsely or wants the lawyer to introduce false evidence, the lawyer should seek to persuade the client that the evidence should not be offered. If the persuasion is ineffective and the lawyer continues to represent the client, the lawyer must refuse to offer the false evidence. If only a portion of a witness' testimony will be false, the lawyer may call the witness to testify but may not elicit or otherwise permit the witness to present the testimony that the lawyer knows is false.

[7] The duties stated in Rule 4-3.3(a) and (b) apply to all lawyers, including defense counsel in criminal cases. In some jurisdictions, however, courts have required counsel to present the accused as a witness or to give a narrative statement if the accused so desires, even if counsel knows that the testimony or statement will be false. The obligation of the advocate under the Rules of Professional Conduct is subordinate to such requirements. See also Comment [9].

[8] The prohibition against offering false evidence only applies if the lawyer knows that the evidence is false. A lawyer's reasonable belief that evidence is false does not preclude its presentation to the trier of fact. A lawyer's knowledge that evidence is false, however, can be inferred from the circumstances. See Rule 4-1.0(f). Thus, although a lawyer should resolve doubts about the veracity of testimony or other evidence in favor of the client, the lawyer cannot ignore an obvious falsehood.

[9] Although Rule 4-3.3(a)(3) only prohibits a lawyer from offering evidence the lawyer knows to be false, it permits the lawyer to refuse to offer testimony or other proof that the lawyer reasonably believes is false. Offering such proof may reflect adversely on the lawyer's ability to discriminate in the quality of evidence and, thus, impair the lawyer's effectiveness as an advocate. Because of the special protections historically provided criminal defendants, however, Rule 4-3.3(a)(3) does not permit a lawyer to refuse to offer the testimony of such a client where the lawyer reasonably believes but does not know that the testimony will be false. Unless the lawyer knows the testimony will be false, the lawyer must honor the client's decision to testify. See also Comment [7].

**Remedial Measures**

[10] Having offered material evidence in the belief that it was true, a lawyer may subsequently come to know that the evidence is false. Or, a lawyer may be surprised when the lawyer's client or another witness called by the lawyer offers testimony the lawyer knows to be false, either during the lawyer's direct examination or in response to cross-examination by the opposing lawyer. In such situations or if the lawyer knows of the falsity of testimony elicited from the client during a deposition, the lawyer must take reasonable remedial measures. In such situations, the advocate's proper course is to remonstrate with the client confidentially, advise the client of the lawyer's duty of candor to the tribunal, and seek the client's cooperation with respect to the withdrawal or correction of the false statements or evidence. If that fails, the advocate must take further remedial action. If withdrawal from the representation is not permitted or will not undo the effect of the false evidence, the advocate must make such disclosure to the tribunal as is reasonably necessary to remedy the situation, even if doing so requires the lawyer to reveal information that otherwise would be protected by Rule 4-1.6. It is for the tribunal then to determine what should be done — making a statement about the matter to the trier of fact, ordering a mistrial, or perhaps nothing.

[11] The disclosure of a client's false testimony can result in grave consequences to the client, including not only a sense of betrayal but also loss of the case and perhaps a prosecution for perjury. But the alternative is that the lawyer cooperates in deceiving the court, thereby subverting the truth-finding process that the adversary system is designed to implement. See Rule 4-1.2(d). Furthermore, unless it is clearly understood that the lawyer will act upon the duty to disclose the existence of false evidence, the client can simply reject the lawyer's advice to reveal the false evidence and insist that the lawyer keep silent. The client could in effect coerce the lawyer into being a party to fraud on the court.

**Preserving Integrity of Adjudicative Process**

[12] Lawyers have a special obligation to protect a tribunal against criminal or fraudulent conduct that undermines the integrity of the adjudicative process, such as bribing, intimidating, or otherwise unlawfully communicating with a witness, juror, court official, or other participant in the proceeding, unlawfully destroying or concealing documents or other evidence, or failing to disclose information to the tribunal when required by law to do so. Thus, Rule 4-3.3(b) requires a lawyer to take reasonable remedial measures, including disclosure, if necessary, whenever the lawyer knows that a person, including the lawyer's client, intends to engage, is engaging, or has engaged in criminal or fraudulent conduct related to the proceeding.

**Duration of Obligation**

[13] A practical time limit on the obligation to rectify false evidence or false statements of law and fact has to be established. The conclusion of the proceeding is a reasonably definite point for the termination of the obligation. A proceeding has concluded within the meaning of this Rule 4-3.3 when a final judgment in the proceeding has been affirmed on appeal or the time for review has passed.

**Ex Parte Proceedings**

[14] Ordinarily, an advocate has the limited responsibility of presenting one side of the matters that a tribunal should consider in reaching a decision; the conflicting position is expected to be presented by the opposing party. However, in any ex parte proceeding, such as an application for a temporary restraining order, there is no balance of presentation by opposing advocates. The object of an ex parte proceeding, nevertheless, is to yield a substantially just result. The judge has an affirmative responsibility to accord the absent party just consideration. The lawyer for the represented party has the correlative duty to make disclosures of material facts known to the lawyer and that the lawyer reasonably believes are necessary to an informed decision.

**Withdrawal**

[15] Normally, a lawyer's compliance with the duty of candor imposed by this Rule 4-3.3 does not require that the lawyer withdraw from the representation of a client whose interests will be or have been adversely affected by the lawyer's disclosure. The lawyer may, however, be required by Rule 4-1.16(a) to seek permission of the tribunal to withdraw if the lawyer's compliance with Rule 4-3.3's duty of candor results in such an extreme deterioration of the client-lawyer relationship that the lawyer can no longer competently represent the client. Also see Rule 4-1.16(b) for the circumstances in which a lawyer will be permitted to seek a tribunal's permission to withdraw. In connection with a request for permission to withdraw that is premised on a client's misconduct, a lawyer may reveal information relating to the representation only to the extent reasonably necessary to comply with Rule 4-3.3 or as otherwise permitted by Rule 4-1.6.

*(Adopted September 28, 1993, eff. July 1, 1995, Rev. July 1, 2007)*

**RULE 4-3.4: FAIRNESS TO OPPOSING PARTY AND COUNSEL**

A lawyer shall not:

(a) unlawfully obstruct another party's access to evidence or unlawfully alter, destroy, or conceal a document or other material having potential evidentiary value. A lawyer shall not counsel or assist another person to do any such act;

(b) falsify evidence, counsel or assist a witness to testify falsely, or offer an inducement to a witness that is prohibited by law;

(c) knowingly disobey an obligation under the rules of a tribunal, except for an open refusal based on an assertion that no valid obligation exists;

(d) in pretrial procedure, make a frivolous discovery request or fail to make reasonably diligent effort to comply with a legally proper discovery request by an opposing party;

(e) in trial, allude to any matter that the lawyer does not reasonably believe is relevant or that will not be supported by admissible evidence, assert personal knowledge of facts in issue except when testifying as a witness, or state a personal opinion as to the justness of a cause, the credibility of a witness, the culpability of a civil litigant, or the guilt or innocence of an accused; or

(f) request a person other than a client to refrain from voluntarily giving relevant information to another party unless:

(1) the person is a relative or an employee or other agent of a client; and

(2) the lawyer reasonably believes that the person's interests will not be adversely affected by refraining from giving such information.

**RULE 4-4.1: TRUTHFULNESS IN STATEMENTS TO OTHERS**

In the course of representing a client a lawyer shall not knowingly:

(a) make a false statement of material fact or law to a third person; or

(b) fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 4-1.6.

**RULE 4-5.3: RESPONSIBILITIES REGARDING NONLAWYER ASSISTANTS**

With respect to a nonlawyer employed or retained by or associated with a lawyer:

(a) a partner, and a lawyer who individually or together with other lawyers possesses comparable managerial authority in a law firm, shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that the person's conduct is compatible with the professional obligations of the lawyer;

(b) a lawyer having direct supervisory authority over the nonlawyer shall make reasonable efforts to ensure that the person's conduct is compatible with the professional obligations of the lawyer; and

(c) a lawyer shall be responsible for conduct of such a person that would be a violation of the Rules of Professional Conduct if engaged in by a lawyer if:

(1) the lawyer orders or, with the knowledge of the specific conduct, ratifies the conduct involved; or

(2) the lawyer is a partner, or has comparable managerial authority in the law firm in which the person is employed, or has direct supervisory authority over the person and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

**RULE 4-8.4: MISCONDUCT**

It is professional misconduct for a lawyer to:

(a) violate or attempt to violate the Rules of Professional Conduct, knowingly assist or induce another to do so, or do so through the acts of another;

****

(c) engage in conduct involving dishonesty, fraud, deceit, or misrepresentation. ....;

(d) engage in conduct that is prejudicial to the administration of justice;

****

*(Adopted Aug. 7, 1985, eff. Jan.1, 1986. Amended Nov. 21, 1995, eff. Jan. 1, 1996; Nov. 25, 2003, eff. Jan. 1, 2004; March 1, 2007, eff. July 1, 2007; June 28, 2011, eff. Jan. 1, 2012; April 27, 2012, eff. July 1, 2012).*

# SILENCE IS NOT NECESSARILY GOLDEN: DISCLOSURE ISSUES IN BANKRUPTCY

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# I. DISCLOSURE AND ADEQUACY OF PLEADINGS

When an attorney is representing a debtor or creditor in bankruptcy it and its client are subject to both state law rules regulating professional conduct, as well as bankruptcy procedural rules which discourage pleadings and other actions that are baseless and without merit. While much attention gets put on a debtor and debtor's counsel with respect to the accuracy of bankruptcy schedules and statement of financial affairs, courts and other parties are with greater frequency focusing on the documents filed by creditors in a bankruptcy case, such as proofs of claims and motions for relief from stay. These materials will provide a general overview of the applicable state and bankruptcy rules regarding disclosure issues.

## A. STATE RULES

### 1. Candor to the Court

While a lawyer "is not required to present an impartial exposition of the law or to vouch for evidence submitted in a cause, the lawyer must not allow the tribunal to be misled by false statements of law or fact or evidence that the lawyer knows to be false." KRPC 3.3. cmt. 2. Both Kansas and Missouri Rules of Conduct provide as follow:

(a) A lawyer shall not knowingly:

> (1) make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer;
>
> (2) fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel; or
>
> (3) offer evidence that the lawyer knows to be false. If a lawyer, the lawyer's client, or a witness called by the lawyer has offered material evidence and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal. A lawyer may refuse to offer evidence, other than the testimony of a defendant in a criminal matter, that the lawyer reasonably believes is false.

(b) A lawyer who represents a client in an adjudicative proceeding and who knows that a person intends to engage, is engaging or has engaged in criminal or

> fraudulent conduct related to the proceeding shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal.
>
> (c) The duties stated in paragraphs (a) and (b) continue to the conclusion of the proceeding and apply even if compliance requires disclosure of information otherwise protected by Rule 1.6.
>
> (d) In an ex parte proceeding, a lawyer shall inform the tribunal of all material facts known to the lawyer which will enable the tribunal to make an informed decision, whether or not the facts are adverse.

KRPC 3.3, MRPC 4-3.3. The purpose of this rule is "to avoid conduct that undermines the integrity of the judicial process." *See* Rule 3.3 cmt. 2.

With respect to representations by a lawyer, comment 3 provides a very cogent summary with respect to the same:

> An advocate is responsible for pleadings and other documents prepared for litigation, but is usually not required to have personal knowledge of matters asserted therein for litigation documents ordinarily present assertions by the client, or by someone on the client's behalf, and not assertions by the lawyer. Compare Rule 3.1. However, an assertion purporting to be on the lawyer's own knowledge, as in an affidavit by the lawyer or in a statement in open court, may properly be made only when the lawyer knows the assertion is true or believes it to be true on the basis of a reasonably diligent inquiry. There are circumstances where failure to make a disclosure is the equivalent of an affirmative misrepresentation. The obligation prescribed in Rule 1.2(d) not to counsel a client to commit or assist the client in committing a fraud applies in litigation. Regarding compliance with Rule 1.2(d), *see* the Comment to that Rule. *See also* the Comment to Rule 8.4(b).

*Id.* at cmt. 3. Further, with respect to a lawyer's legal argument to the court, if the same is knowingly based upon a false representation of the law, then the same constitutes dishonesty to the court. In this respect, lawyers have an affirmative responsibility to disclose "directly adverse authority in the controlling jurisdiction" even if the other side had not disclosed the same. *Id.* at cmt. 4.

**2. Meritorious Claims**

A lawyer "has a duty to use legal procedure for the fullest benefit of the client's cause, but also a duty not to abuse legal procedure." KRPC 3.1, MRPC 4-3.1 cmt. 1. This duty is outlined in Rule 3.1: "A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis for doing so that is not frivolous, which includes a good faith

argument for an extension, modification or reversal of existing law...." KRPC 3.1, MRPC 4-3.1. As recognized in the comments, "the law is not always clear and never is static. Accordingly, in determining the proper scope of advocacy, account must be taken of the law's ambiguities and potential for change." KRPC 3.1, MRPC 4-3.1 cmt. 1.

Comment 2 to the Rule gives some general parameters of what is and is not a frivolous action:

> The filing of an action or defense or similar action taken for a client is not frivolous merely because the facts have not first been fully substantiated or because the lawyer expects to develop vital evidence only by discovery. What is required of lawyers, however, is that they inform themselves about the facts of their clients' cases and the applicable law and determine that they can make good faith arguments in support of their clients' positions. Such action is not frivolous even though the lawyer believes that the client's position ultimately will not prevail. The action is frivolous, however, if the client desires to have the action taken primarily for the purpose of harassing or maliciously injuring a person or if the lawyer is unable either to make a good faith argument on the merits of the action taken or to support the action taken by a good faith argument for an extension, modification or reversal of existing law.

KRPC 3.1, MRPC 4-3.1 cmt. 2.

### B. Applicable Bankruptcy Provisions and Rules

#### 1. 11 U.S.C. § 105(a)

As recognized by the Supreme Court, the bankruptcy court has broad authority to prevent an abuse of process. *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365, 375 (2007). This authority emanates from Section 105(a) of the Bankruptcy Code, which states:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, *sua sponte*, taking any action or *making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.*

11 U.S.C. § 105(a) (emphasis added). *See also In re Courtesy Inns, Ltd.*, 40 F.3d 108 (10th Cir. 1994) (finding Section 105 gives bankruptcy court inherent power to sanction conduct abusive of the judicial process); *In re Clark*, 223 F.3d 859, 864 (8th Cir. 2000) (same); *In re Thomas*, 2008 WL 4570267 (10th Cir. 2008) (same). While Section 105(a) is broad, it is not boundless. As Judge Somers has recognized:

> [I]t should be universally recognized that the power granted to the bankruptcy courts under section 105 is not boundless and should not be employed as a panacea for all ills confronted in the bankruptcy case. Section 105 does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code or mandates of other state and federal statutes. As aptly put by one court, section 105 does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity.

*In re Blagg*, 372 B.R. 502, 509 (Bankr. D. Kan. 2007).

**2. Bankruptcy Rule 9011**

"Pursuant to Bankruptcy Rule 9011(b), an attorney or *pro se* party who presents a document (whether by signing, filing, submitting, or later advocating) certifies, among other things, that 'the allegations and other factual contentions have evidentiary support, or if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery.'" *Lafayette v. Collins (In re Withrow)*, 405 B.R. 505, 512-13 (1st Cir. B.A.P. 2009) (quoting FED. R. BANKR. P. 9011(b)). "Pursuant to Bankruptcy Rule 9011(c), if, after notice and an opportunity to respond, the bankruptcy court determines that an attorney has violated Bankruptcy Rule 9011(b), it may impose 'an appropriate sanction.'" *Id.* at 513 (citing FED. R. BANKR. P. 9011(c)).

Once there has been a violation of Rule 9011, it is in the bankruptcy court's discretion to determine what sanctions are appropriate. *Id.* at 514. When determining whether to impose a sanction and the type of the same, a bankruptcy court will consider the following:

> whether the conduct was willful, or negligent; whether it was part of a pattern of activity, or an isolated event; whether it infected the entire pleading, or only one particular count or defense; whether the person has engaged in similar conduct in other litigation; whether it was intended to injure; what effect it had on the litigation process in time or expense; whether the responsible person is trained in the law, what amount, given the financial resources of the responsible person, is needed to deter that person from repetition in the same case; and what amount is needed to deter similar activity by other litigants.

*In re Thomson*, 329 B.R. 359, 362 (Bankr. D. Mass. 2005). The above list is not an exclusive of any other factor that the bankruptcy court may wish to consider. *Id.*

Sanctions have a dual purpose: deterrence and compensation. *Withrow*, 405 B.R. at 514. "In cases of deterrence, the court must limit the sanction to what is sufficient to deter repetition

of such conduct or comparable conduct by others similarly situated." *Id.* (internal quotations and citation omitted). *See also* FED. R. BANKR. P. 9011(c)(2). "In cases of compensation, the reasonable costs incurred as a result of the sanctionable conduct may appropriately form the sanction." *Withrow*, 405 B.R. at 514 (citations omitted).

### 3. 11 U.S.C. § 527 – Debtor Relief Agency Disclosures

Section 527 requires "debt relief agencies" to make several disclosures to an "assisted person." Subject to certain specific exceptions, a debt relief agency is defined, in part, as "any person provides bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration...." 11 U.S.C. § 101(12A). An "assisted person" is "any person who debts consist primarily of consumer debts and the value of whose nonexempt property is less than $164,250." 11 U.S.C. § 101(3). Attorneys are ***not*** exempted out of the definition of "debt relief agency." *Milavetz, Gallop & Milavetz, P.A. v. U.S.*, 130 S.Ct. 1324, 1332 (2010). The disclosures required by Section 527 include a written notice requirement (i) outlining the various types of bankruptcy relief, (ii) informing the debtor that the information provided in the petition and schedules must be complete, accurate and truthful, (iii) that the information provided may be audited, and (iv) information about the services from an attorney or petition preparer. See 11 U.S.C. § 527. A copy of the various notices required by a debt relief agency are required to be kept for two years after the date such notices are given. *See* 11 U.S.C. § 527(d).

It should be noted that while being a debt relief agency triggers several disclosures, there are also prohibitions of what an attorney may say to their client. *See* 11 U.S.C. § 526. One of the most controversial prohibitions is that a debt relief agency is prohibited from:

> advis[ing] an assisted person or prospective assisted person to incur more debt in contemplation of such person filing a case under this title or to pay an attorney or bankruptcy petition preparer a fee or charge for services performed as part of preparing for or representing a debtor in a case under this title.

11 U.S.C. § 526(a)(4). The Supreme Court in *Milavetz* construed this to mean "that § 526(a)(4) prohibits a debt relief agency only from advising an assisted person to incur more debt when the impelling reason for the advice is the anticipation of bankruptcy." *Milavetz*, 130 S.Ct. at 1336.

### 4. 11 U.S.C. § 707(b)(4) - Schedules and Statement of Financial Affairs

Upon filing a bankruptcy case, a debtor is required to file schedules of its assets and liabilities and a statement of its financial affairs. *See* 11 U.S.C. § 521(a)(1). One of the BAPCPA amendments concerned proper disclosures with respect to the schedules and statement of financial affairs and debtor's counsel obligation with respect to the same. *See* 11 U.S.C. § 707(b)(4). "[U]nder new §§ 707(b)(4)(C) and (D) (as revised by BAPCPA), a debtor's attorney has a duty, equivalent to that under Bankruptcy Rule 9011, to perform a reasonable investigation into the circumstances giving rise to the documents before filing them in a chapter 7 case. For example, under new § 707(b)(4)(C), attorneys are subject to an automatic certification of meritoriousness, based upon a reasonable investigation, as to any "petition, pleading, or written motion" signed by them." *Id.* (quoting 11 U.S.C. § 707(b)(4)(C)).

"Furthermore, under new § 707(b)(4)(D), an attorney's signature on a client's bankruptcy petition is deemed a representation that 'the attorney has no knowledge after an inquiry that the information in the schedules filed with such petition is incorrect.'" *Id.* (quoting 11 U.S.C. § 707(b)(4)(D)). "Accordingly, any attorney who files schedules and statements on a debtor's behalf makes a certification regarding the representations contained therein. Although the certification is not an absolute guaranty of accuracy, it must be based upon the attorney's best knowledge, information and belief, formed after an inquiry reasonable under the circumstances." *Id.* (internal quotations and citation omitted). Courts have found that the proper standard is an objective one of reasonableness under the circumstances. *Id.* "Courts, therefore, must inquiry as to whether a reasonable attorney in like circumstances could believe his actions to be factually and legally justified." *Id.* (internal quotations and citation omitted).

In order to determine whether debtor's counsel has fulfilled its statutory duty, a court should ask the following questions:

> (1) did the attorney impress upon the debtor the critical importance of accuracy in the preparation of documents to be presented to the Court; (2) did the attorney seek from the debtor, and then review, whatever documents were within the debtor's possession, custody or control in order to verify the information provided by the debtor; (3) did the attorney employ such external verification tools as were available and not time or cost prohibitive (e.g., on-line real estate title compilations, on-line lien search, tax "scripts").

*In re Dean*, 401 B.R. 917, 924 (Bankr. D. Idaho 2008).

In addition to the sanctions that may be imposed under Bankruptcy Rule 9011, "§ 707(b)(4) provides authority for bankruptcy courts to order the attorney for the debtor to reimburse the trustee for reasonable costs in prosecuting a § 707(b) motion brought by the trustee if the court grants the motion and 'finds that the action of the attorney for the debtor in filing a case under this chapter violated [Bankruptcy R]ule 9011.'" *Withrow*, 405 B.R. at 513 (quoting 11 U.S.C. § 707(b)(4)(A)).

In *Withrow*, the First Circuit Bankruptcy Appellate Panel ("BAP") affirmed the bankruptcy court's order imposing sanctions against debtor's counsel for violating Code § 707(b)(4) and Rule 9011. The BAP affirmed the bankruptcy court's finding that:

> On the facts here, this Court cannot find that [debtor's counsel] has met his Rule 9011 and § 707(b)(4)(C) obligations. After all of the argument and testimony, the Court still is not sure what the Debtor earned in the six months prior to the filing of the petition or what the Debtor earns now. Nor is the Court sure whether the Debtor intended to mislead the Court with respect to the information provided in his bankruptcy papers or his Section 341 meeting testimony. But the Court is sure of this-that [debtor's counsel], at the very least, failed to (1) properly review information provided by the Debtor with respect to his prepetition income; (2) identify contradictions and inconsistencies in the schedules, Statement of Financial Affairs, Rebuttal and affidavits submitted on behalf of the Debtor before the filing of those documents; (3) promptly correct those contradictions and inconsistencies, even when identified by the Chapter 7 Trustee, on anything close to a timely basis; and (4) to place himself in a position of being able to explain the reasons for those contradictions and inconsistencies to the Court even in the context of an evidentiary hearing of which he had more than adequate notice. Certainly, there is no bright line that surrounds § 707(b)(4)(C) and (D) and Rule 9011. But wherever that line lies, this Court agrees with the Chapter 7 Trustee and the UST that [debtor's counsel] has crossed it.

*Withrow*, 405 B.R. at 510 (quoting *In re Withrow*, 391 B.R. 217, 229 (Bankr. D. Mass. 2008)).

Further, the BAP affirmed the bankruptcy court's decision in finding that sanctions were warranted. In determining the nature and amount of the sanctions, the bankruptcy court looked back at the attorney's past conduct and noted that he had "a history of 'sloppy, careless and unprofessional' practices in representing consumer debtors." *Withrow*, 405 B.R. at 514 (quoting *Withrow*, 391 B.R. at 229). Accordingly, the bankruptcy court found that sanctions were appropriate because debtor's counsel had not recognized and taken steps to correct his practices. *Id.* As a result, the bankruptcy court awarded sanctions representing three times the amount which debtor's counsel charged his client. *Id.*

In *In re Nunez*, the bankruptcy court ordered the disgorgement of fees ($5,450) and sanctions ($13,000) from debtor's counsel for serious mishandling of a debtor's bankruptcy case. *See In re Nunez*, Case No. 08-44291, Doc. No. 62 (Bankr. W.D. Mo. May 11, 2009) (unpublished decision). In *Nunez*, the bankruptcy court found the following items of misconduct:

- "[Debtor's counsel] has committed fraud with respect to certain funds delivered to him by Debtor from the sale of the Debtor's motorcycle that were to be deposited in [Debtor's counsel's] law firm's trust account, and with respect to his representation of Debtor in this case;"
- "[Debtor's counsel] deducted certain funds from the law firm's trust account without authorization by Debtor or this Court;"
- "[Debtor's counsel] did not review the bankruptcy petition, schedules, and statements with Debtor and filed them without her signature;"
- "[Debtor's counsel] did not provide a copy of the notice required by § 342(b) to Debtor, notwithstanding his declaration on the original petition that he had done so;"
- "[Debtor's counsel] did not have Debtor sign and review the Rights and Responsibilities Agreement required by Local Rule 2016-D, despite his certification to the Court that he had done so;"
- "[Debtor's counsel] did not provide to Debtor the disclosures required by § 527 related to 'debt relief agencies;'"
- "[Debtor's counsel] Disclosure of Compensation by Attorney for Debtor dated October 13, 2008, was materially false, and he did not amend the statement to correct it until December 22, 2008, the same date he was suspended from practice by the Supreme Court of Missouri;"
- "[Debtor's counsel] did not personally attend the § 341 meeting of creditors;"
- "[Debtor's counsel] failed to keep Debtor informed and advised as to the status of her bankruptcy case;"
- "During the course of [Debtor's counsel] representation of Debtor, he provided Debtor fraudulent advice regarding whether the assets of the grantor trust he established for Debtor were subject to attachment by creditors and whether they were assets of her bankruptcy estate;" and
- "[Debtor's counsel] filed schedules and statements that were so inaccurate that he failed to satisfy the requirements of § 707(b)(4)(C) or Rule 9011."

*Id.* It should also be noted that filing a petition without the debtor's signature constitutes a Rule 9011 violation. *See Briggs v. LaBarge (In re Phillips)*, 317 B.R. 518 (8th Cir. B.A.P. 2004).

In *In re Kane*, 2010 WL 2757346 (Bankr. N.D. Cal. 2010), the bankruptcy court awarded the trustee sanctions against the debtor's attorney in the amount of $20,000. Kane was a Chapter 7 case. The debtor lied on her schedules failing to disclose a $72,000 promissory note. The trustee discovered the same and moved to reopen the case and the debtor's discharge was eventually revoked. The debtor testified in a deposition (which debtor's counsel left half way through) that "all they had to do was disclose the court case that result in the note, after which it would be up to the bankruptcy trustee to 'investigate the matter, to pull the file and to find out the specifics' of the note." Further, the debtor led the trustee to believe at the 341 hearing that the note was of minimal value, notwithstanding just eight days after the case was closed, he sought enforcement of the note in state court.

The trustee then sought civil sanctions against the debtor's attorney. The bankruptcy court found that debtor's counsel had violated Rule 9011(b) and § 707(b)(4)(D), sanctioned him $20,000, and transmitted the decision to the United States Attorney and the State Bar of California. It should be noted that the bankruptcy court observed that if everything alleged by the trustee was true, then the debtor's attorney conduct was criminal.

In *In re Trudell*, 424 B.R. 786 (Bankr. W.D. Mich. 2010), the debtors failed to schedule tax refunds and moved to amend their schedules with respect to the same. The debtors attempted to exempt the tax refunds and the trustee objected. The court did not find that the debtor acted intentionally or reckless citing as a mitigating factor their attorney's involvement in the same. While the court excused the debtors, it scheduled a hearing on potential sanctions against the their attorney under § 707(b)(4)(d) because the attorney assisted in preparing the schedules.

In *In re Burton*, 442 B.R. 421 (W.D. N.C.), the bankruptcy administrator filed an omnibus motion with respect to debtor's counsel conduct in 12 separate cases. The accusations, among other things, including false advertising, submitting false pleadings, lack of diligence, instructing the client to lie at a 341 hearing. The Court found that in the 12 separate cases that debtor's counsel engaged in (i) misleading advertising, (ii) violation of local bankruptcy and state ethics rules regarding scope of representation and withdrawal from cases, (iii) improperly violated the automatic stay and local bankruptcy "no look" policy in her collection of fees, (iv)

filed petitions and plans in bad faith, (v) made misrepresentations to the court and other parties, and (iv) engaged in systematic malpractice, including lack of competency and diligence.

The bankruptcy court sanctioned debtor's counsel as follows: (i) suspended debtor's counsel from practicing before the bankruptcy court for an indefinite period, not less than 12 months, (ii) after 12 months, debtor's counsel could seek reinstatement, but must abide by the bankruptcy and ethical rules and certify to various remedial steps, including attending 20 hours of CLE on bankruptcy topics and 10 hours on professional ethics, read the local and ethical rules, and abstained from the use of drugs and alcohol for the 12 months prior to seeking reinstatement. Additionally, debtor's counsel was required to refund the fees to her clients that were named in the motion. *Id.* at 468-69.

**5. Fraudulent Claims**

One of the most frequent documents filed in bankruptcy is the proof of claim. At the bottom of the official proof of claim form (Form B10) is the following phrase: "Penalty for presenting fraudulent claim: Fine of up to $500,000 or imprisonment for up to 5 years, or both. 18 U.S.C. §§ 152 and 3571." This statement references the bankruptcy fraud statute. Section 157 provides that;

> A person who, having devised or intending to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice or attempting to do so .... files a document in a proceeding under title 11, including a fraudulent involuntary bankruptcy petition under section 303 of such title; or makes a false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under title 11, including a fraudulent involuntary bankruptcy petition under section 303 of such title, at any time before or after the filing of the petition, or in relation to a proceeding falsely asserted to be pending under such title ... shall be fined under this title, imprisoned not more than 5 years, or both.

18 U.S.C. § 157. Further, as stated the current fine for making a fraudulent claim is $500,000. *See* 18 U.S.C. § 3571. It should also be noted that if the attorney signs the false claim, then it could be subject to Rule 9011 sanctions.

**6. Dischargeability Complaints**

Additionally, in certain cases, a creditor's specific claim may be excepted from the debtor's discharge. *See* 11 U.S.C. § 523. Pursuant to Section 523(a)(2), the following claims may be excepted:

- Claims "for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by false pretenses, a false representation, or actual fraud (§ 523(a)(2)(A));
- Claims "for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by use of a materially false written statement with respect to either the debtor's or an insider's financial condition, which the creditor relied. Additionally, the debtor must have made or published such statement with the intent to deceive (§ 523(a)(2)(B)); and
- Certain claims that arise from the purchase of luxury goods and/or cash advances (§ 523(a)(2)(B)).

However, "[i]f a creditor requests a determination of dischargeability of a consumer debt under [11 U.S.C. § 523(a)(2)], and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney's fee for, the proceeding if the court finds that the position of the creditor was not substantially justified, except that the court shall not award such costs and fees if special circumstances would make the award unjust." 11 U.S.C. § 523(d). "The purpose of the provision is to discourage creditors from initiating proceedings to obtaining a false financial statement exception to discharge in the hope of obtaining a settlement from an honest debtor anxious to save attorney's fees. Such practices impair the debtor's fresh start and are contrary to the spirit of the bankruptcy laws." House Report No. 95-595, 95th Cong. 1st Sess. 365 (1977).

**7. Involuntary Petitions**

There are generally two general categories of bankruptcy cases: voluntary and involuntary. A voluntary bankruptcy is one where the debtor upon its own volition commences a case by filing a petition under the appropriate chapter (e.g., Chapter 7, 13, etc.). *See* 11 U.S.C. § 301. A majority of bankruptcies are voluntary. An involuntary bankruptcy is one that is commenced by the Debtor's creditors (generally three or more) by filing an involuntary petition. *See* 11 U.S.C. § 303(b). A debtor may contest the filing of an involuntary bankruptcy or consent to relief being sought and, if appropriate, convert the case to another chapter under the Bankruptcy Code.

Before filing an involuntary petition, however, a creditor should make sure it has a solid basis in doing so. If the debtor is successful in defeating an involuntary petition, then it may be entitled to its costs and reasonable attorneys' fees. *See* 11 U.S.C. § 303(i)(1). Further, if the bankruptcy court finds that the involuntary petition was filed in bad faith, then the debtor may be entitled to any damages proximately caused by the filing or punitive damages. *See* 11 U.S.C. § 303(i)(2).

**8. Motions for Relief From Stay**

In Kansas, a motion seeking stay relief must contain the following information:

- Copies of documents on which the claim is based, including loan documents and documents evidencing both the grant of the lien, security interest, mortgage or other encumbrance, and its proper perfection or proper recordation;
- The balance owing on the petition date, and the date and amount of any payments received since the filing;
- The number of payments the debtor is in arrears, and the amount of each payment, including the total arrearage on the petition date;
- The movant's best estimate of the collateral's value; and
- the identity of any person or entity claiming an interest in the property that is the subject of the motion and of whom movant is aware.

LBR 4001(a).1(d). In a Chapter 13, if a party is seeking stay relief on account of a post-petition default on a residence or longer term debt, then the motion must contain the following:

- a legible post-petition payment history listing the date each post-petition payment was received, the amount of each post-petition payment, and how each post-petition payment was applied;

- an itemization of any other expenses or fees due postpetition, including attorney fees, filing fees, late payment fees, and escrow advances;
- the total dollar amount necessary to cure the postpetition debt on a date certain; and
- the address where the current monthly payment is to be mailed if the mailing address is not listed in the movant's filed proof of claim or if the mailing address has changed.

LBR 4001(a).1(e).

In Missouri, a motion for relief from stay must contain the "the amount of the balance due of principal and interest as of the date of the bankruptcy petition". MOW 4001-1(B). In "Chapter 7 cases, if the motion is filed prior to the §341 Meeting of Creditors, the motion shall state an estimate of the value of the collateral." *Id.* Further, in Chapter 13 cases, where the creditor is seeking relief on account of failure to make post-petition payments on the debtor's residence, then the motion must contain a post-petition payment history which will contain when each post-petition was received, the amount received, how the payment was applied. *Id.* Additionally, the creditor is required to serve legible paper copies of all documents evidencing perfection of security interests on the trustee and debtor's counsel at the time of the filing of the motion for relief or promptly thereafter. MOW 4001-1(F). Alternatively, as to mortgages and deeds of trust only, the movant may file the page of the document, showing recording information, and the signatures of the borrowers. However, if this method is used, the creditor is required to promptly provide paper copies of the entire document upon specific request from the trustee or debtor's counsel. *Id.*

### 9. Creditor Disclosure Case Examples

Courts are with more frequency reviewing the processes and conduct of creditors' counsel in handling matters before the bankruptcy courts, especially those attorneys with high volume practices. The bankruptcy court in *In re Taylor*, did a very thorough behind the scenes analysis of what can occur in a high volume practice when the parties effectively cease communicating with each other. *See In re Taylor*, Case No. 07-15385, Doc. No. 193 (Bankr. E. D. Penn. Apr. 15, 2009) (unpublished decision). As described by the court, HSBC has implemented a electronic information system called NewTrak, which manages its defaulted loans. While such a system may provide and economically efficient system, it can also create

havoc. In *Taylor*, issues arose either because of shortcomings in the NewTrak system or the various parties failure to appropriately use the same and/or communicate with one another. In particular, the court was particularly disturbed by the fact that the lawyers involved failed to directly communicate with their client.

The first issue arose with respect to the HSBC's proof of claim. The proof of claim filed by HSBC was prepared by national counsel. In preparing the proof of claim, the data is received from a computer system by a non-attorney, reviewed and then entered into a standard proof of clam form. The proof of claim is then inspected by another non-attorney quality control person. Then, the attorney's signature is electronically affixed with the attorney reviewing only about 10% of the claims that are filed with her signature. *Taylor*, *supra*, at 8-10. In *Taylor*, the proof of claim that was filed failed to attached the correct note and the incorrect payment amount was claimed. *Id.* at 10. Additionally, it was not reviewed by the attorney who signed it or by a person at HSBC. *Id.* at 42.

Given the errors in the proof of claim, the same was objected to by the debtor. The claim objection was handled by a local firm different from the firm that prepared the proof of claim. The two firms never communicated with each other with respect to the claim objection. *Id.* at 30. Without sufficient information, the local firm filed a response to the claim objection, which had it done more due diligence would noticed the various defects in the claim. The hearing on the claim objection was continued several times because the local counsel could not get the loan history. However, as the facts indicate, the local firm relied upon the computer system rather than attempting to directly contact HSBC. *Id.* at 42-47.

Finally, the local firm filed a motion for stay relief. The court found that it was a fundamentally misleading pleading. *Id.* at 35. It represented that the debtors had failed to make their regular monthly payments, when in fact they had. Further, rather than have a witness ready to testify as to the basis of the motion, the local law firm submits requests for admission at the same time it files its motion for relief. While the debtor's counsel failed to respond to the admissions, the local law firm attempted use them anyway despite knowing that they were incorrect. *Id.* at 51.

In the end, the court found several instances where Rule 9011 had been violated. In assessing sanctions, the debtor did not award any monetary sanctions on account of the money

spent by the various law firms in connection with responding to the court's inquires and loss of productivity. *Taylor*, *supra*, at 51-52. Instead, the court arrived at the following sanctions:

- **Supervising attorney for the local law firm.** She was found to have failed to observe her duty to make reasonable inquiry with respect to the documents she signed (the motion for stay relief and the claim objection). What disappointed the court is that the supervisor did not appear to comprehend the shortcomings of her conduct. The court believed that she was "so enmeshed in the assembly line of managing the bankruptcy department's volume mortgage lender practice that she has lost sight of her duty to the court and has compromised her ethical obligations." *Id.* at 52. Accordingly, to assist her in finding the same, she was ordered to participate in an additional three credits of continuing legal education in professional responsibility/ethics. *Id.*

- **Trial attorney for the local law firm.** The court took pity on the young lawyer that was seemingly thrown under the bus by his superiors. The court felt that while the young attorney did violate Rule 9011, the proceedings have been very hard on him and not further punishment was necessary. *Id.*

- **Head of the local law firm.** As head of the law firm, the court found that he had very little knowledge on how the very systems worked. Further, the court found that the "culture of the firm of he has fostered appears to value production over professionalism, a priority acceptable for a business but potentially antagonistic to the practice of law." *Id.* at 53. The court found that he might not be aware of the questionable practices that his law firm had engaged in. As a result, the court ordered him to obtain training on NewTrak and spend day with his employees observing how the same is used. Also, he and the supervising attorney were directed conduct a training session for all of the members of the firm's bankruptcy group in the appropriate use of NewTrak, when it is appropriate to call the client directly, and the requirements of Rule 9011. *Id.* at 53.

- **HSBC.** HSBC was directed to prepare and send a letter, along with the opinion, to the law firms that make up its national network describing when it is appropriate to contact the client directly. Further, HSBC was to inform the firms that direct contact will not adversely effect their standing with HSBC. *Id.* at 55.

In short, the core issues that the court appears to have been most troubled by is that all of the problems may have been avoided had parties just picked up the telephone and talked to one another rather than have blind reliance on the NewTrak system. Moreover, the court was also enraged by the total lack of accountability exhibited by the local law firm with respect to this case. In conclusion, the court very eloquently states what attorneys' responsibilities should be in this technological age:

> Finally, it is my hope that by bringing the NewTrak process to the light of day in a published opinion, systemic changes will be made by the attorneys and lenders who employ the system or at least help courts formulate the right questions when they have not. While NewTrak has many features that make a volume business process more efficient, the users may not abandon their responsibility for fairness and accuracy to the seduction of electronic communication. The escalation procedures in place at HSBC and the [local law firm] existed on paper only. When an attorney appears in a matter, it is assumed he or she brings not only substantive knowledge of the law but judgment. The competition for business cannot be an impediment to the use of these capabilities. The attorney, as opposed to a processor, knows when a contest does not fit the cookie cutter forms employed by paralegals. At that juncture, the use of technology and automated queries must yield to hand-carried justice. The client must be advised, questioned and consulted. Young lawyers must be trained to make those judgments as opposed to merely following the form manual. Until they are capable of doing so, they should be supported and not left to sink or swim alone in an effort for the firm to be more profitable by leveraging the cheapest labor.
>
> At issue in these cases are the homes of poor and unfortunate debtors, more and more of whom are threatened with foreclosure due to the historic job loss and housing crisis in this country. Congress, in its wisdom, has fashioned a bankruptcy law which balances the rights and duties of debtors and creditors. Chapter 13 is a rehabilitative process with a goal of saving the family home. The thoughtless mechanical employment of computer-driven models and communications to inexpensively traverse the path to foreclosure offends the integrity of our American bankruptcy system. It is for those involved in the process to step back and assess how they can fulfill their professional obligations and responsibly reap the benefits of technology. Nothing less should be tolerated.

*Taylor*, *supra*, at 57-58.

Similar to *Taylor*, the court in *McDermott v. Countrywide Home Loans (In re O'Neal)*, Adv. No. 08-5031, Doc. No. 84 (Bankr. N. D. Ohio May 1, 2009) (unpublished decision) ("*O'Neal I*"), also criticized a large financial institution's handling of a bankruptcy case. In *O'Neal*, Countrywide agreed to a short sale in full satisfaction of the debt owed to it by the debtor. For various reasons, however, the loan was never closed. The debtor subsequently filed for bankruptcy.

While Countrywide was not listed on the schedules, it did receive notice of the bankruptcy. Despite having its debt satisfied, Countrywide retained local counsel, filed a proof of

claim, and objected to the Chapter 13 plan. Debtor objected to Countrywide's claim, which was sustained. Countrywide voluntarily withdrew its objection to confirmation.

The United States Trustee initiated an adversary proceeding against Countrywide alleging that Countrywide engaged in conduct that abused judicial process. After making a detailed findings of fact, the court found:

> The test for imposing such sanctions is whether the individual's conduct was reasonable under the circumstances, or was reckless. A party is reckless when it knows, or has reason to know . . . of facts which create a high degree of risk of . . . harm to another, and deliberately proceeds to act, or fail to act, in conscious disregard of, or indifference to, that risk. Countrywide's system is reckless. It appears to me designed to allow each actor in the process to act with indifference to the truth, and to rely solely on the limited information made available at each step. It is no defense that the actors in the process made mistakes, the system allows those mistakes to be hidden from the view of the next actor in the chain; thereby encouraging this type of error, or at a minimum, delaying the discovery of these errors. The errors in this case were plentiful, from the failure to properly account for the receipt of short sale funds to the failure to correctly identify the holder of the Note and Mortgage. They evidence Countrywide's disregard for diligence and accuracy. The cumulative impact of each of the errors in this case rises to the level of sanctionable conduct in this case.

*O'Neal I*, *supra*, at 20-21 (quotations and citations omitted). After finding that Countrywide's conduct was sanctionable, the court set the matter for trial to determine the nature of the sanctions. After the trial, the court imposed the following sanctions:

> Therefore, beginning immediately, Countrywide and its successors and assigns are ordered to complete the attached worksheet (the "Worksheet") for each new proof of claim filed by Countrywide, its successors or assigns before this Court. A copy of the completed Worksheet shall be attached to the proof of claim at the time of filing. In addition, within 75 days from the date of this Order, Countrywide, its successors and assigns are ordered to complete the Worksheet for all previously filed proofs of claim in cases currently pending on this Court's docket and file a copy of the completed Worksheet as a supplement to the previously filed proof of claim. If Countrywide, its successors and assigns fail to use and properly complete the Worksheet in support of their claims, the Court will award monetary sanctions against Countrywide, its successors and/or assigns including, but not limited to, a minimum of $300 for attorney's fees incurred by the debtor or trustee in contesting the claims of Countrywide, its successors and/or assigns, as well as any other compensatory damages that the debtor might prove.

*McDermott v. Countrywide Home Loans (In re O'Neal)*, Adv. No. 08-5031, Doc. No. 98 at 9-10 (Bank. N. D. Ohio July 31, 2009) (unpublished decision) ("*O'Neal II*"). While proofs of claim and motions for relief often times seem to be rather mundane filings, courts do take the same seriously as should counsel. The consequences of failing to do so can result not only in monetary damages, but also can subject the parties involved to embarrassment and loss of productivity and reputation.

# II. EMPLOYMENT AND COMPENSATION OF PROFESSIONALS

## A. EMPLOYMENT ISSUES

The Code requires that a debtor-in-possession, trustee, and official committee obtain bankruptcy court approval before employing professionals. *See* 11 U.S.C. §§ 327, 1103(a). Professionals that are regularly retained are attorneys, accountants, financial advisors and auctioneers, but the definition of professional is not limited to these classes of professionals. In order to be properly employed by the bankruptcy estate, the professional must timely submit an employment application and affidavit of disinterestedness to the bankruptcy court. *See* FED. R. BANKR. P. 2014. "An applicant under § 327(a) has the burden of establishing, by that application and accompanying affidavit, that its chosen professional is qualified." *In re Shore*, 2004 WL 2357992 at *4 (Bankr. D. Kan. 2004). However, a debtor's and trustee's "choice of counsel is entitled to great deference." *Id.*

The employment application generally sets forth the terms and conditions of the employment. The affidavit of disinterestedness sets forth that the professional does not hold an adverse interest to the bankruptcy estate and the professional is a disinterested person as defined by the Code. The affidavit is also where any unique relationships that the professional may have with the debtor or other parties in interest should be fully disclosed.

To be employed by the estate, the main criteria is that the proposed professional cannot hold an adverse interest to the bankruptcy estate and that the professional must be a "disinterested person." *See* 11 U.S.C. §§ 101(14); 327(a). "A 'disinterested person' is one that 'does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection

with, or interest in, the debtor, ... or for any other reason.'" *In re Git-N-Go, Inc.*, 321 B.R. 54, 58 (Bankr. N. D.Okla. 2004) (quoting 11 U.S.C. § 101(14)(E)). Some courts have held that Code § 101(14)(E) "only applies to a law firm when the law firm itself holds a materially adverse interest and not where the firm simply represents an entity that may hold a materially adverse interest." *In re Huntco, Inc.*, 288 B.R. 229, 233 (Bankr. E.D. Mo. 2002) (citing *In re AroChem Corp.*, 176 F.3d 610, 629 (2d Cir. 1999); *In re BH & P*, 949 F.2d 1300, 1310 (3rd Cir. 1991)). *But see Git-N-Go, Inc.*, 321 B.R. at 58 ("In determining whether a professional has or represents an 'adverse interest,' one court observed: '[I]f it is plausible that the representation of another interest may cause the debtor's attorneys to act any differently than they would without that other representation, then they have a conflict and an interest adverse to the estate.'")(quoting *In re The Leslie Fay Cos.*, 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994)).

There are, however, certain exceptions to the general rule of representing adverse interests. For instance, under Code § 327(e), a trustee or debtor-in-possession can employ "for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed." 11 U.S.C. § 327(e).

Additionally, Code § 327(c) "specifically states that a person is not disqualified from employment solely because of such person's employment or representation of a creditor." *Williams v. Marlar (In re Marlar)*, 248 B.R. 577, 580 (Bankr. W.D. Ark. 2000). If an objection is raised to the employment of a professional by a creditor or the United States Trustee based upon the representation of a creditor, then the Court "must disapprove the employment only if there is an actual conflict of interest." *Id.*

The Code does not define "actual conflict of interest" and "[c]ourts have been accorded considerable latitude in using their judgment and discretion in determining whether an actual conflict exists in light of the particular facts of each case." *In re Pappas*, 216 B.R. 87, 92 (Bankr. D. Conn. 1997) (internal quotes and citation omitted). In this regard, some courts have found that "[a]n actual conflict exists if there is 'an active competition between two interests, in which one interest can only be served at the expense of the other.'" *Git-N-Go, Inc.*, 321 B.R. at 58 (quoting *In re BH & P, Inc.*, 103 B.R. 556, 563 (Bankr. D.N.J. 1989), *aff'd in pertinent part*, 119 B.R. 35 (D.N.J.1990)).

Some courts, however, have found that "[i]n order to obtain disqualification of an attorney based upon the prior representation of a creditor, something more than the dual representation must be shown." *Marlar*, 248 B.R. at 580. "With respect to dual representation of a *creditor* and the trustee, '[r]easoning by analogy to section 327(e), several courts have held that, where the trustee seeks to appoint counsel only as 'special counsel' for a specific matter, there need only be no conflict between the trustee and the counsel's creditor client with respect to the specific matter itself.'" *Pappas*, 216 B.R. at 92 (quoting *Stumbos v. Kilimnik*, 988 F.2d 949, 964 (9th Cir. 1993)). *See also In re AroChem Corp.*, 176 F.3d at 626; *Nisselson v. Wong (In re Best Craft General Contractor and Design Cabinet Inc.)*, 239 B.R. 462, 467-69 (Bankr. E.D. N.Y. 1999); *Altenberg v. Schiffer (In re Sally Shops, Inc.)*, 50 B.R. 264, 266 (Bankr. E.D. Penn. 1985). Further, some courts have found that there is not an actual conflict of interest on a matter when the creditor and the trustee's interests are "parallel" or "aligned." *See In re Development Corp. of Plymouth, Inc.*, 283 B.R. 464, 469 (Bankr. E.D. Mich. 2002); *In re Mundo Custom Homes, Inc.*, 214 B.R. 356, 362 (Bankr. N.D. Ill. 1997); *In re Milford Group, Inc.*, 164 B.R. 899, 902 (Bankr. M.D. Penn. 1993).

In some cases, courts have found that an actual conflict of interest exists. *See, e.g., In re American Energy Trading, Inc.*, 291 B.R. 154 (Bankr. W.D. Mo. 2003); *Sturgeon State Bank v. Perkey (In re Perkey)*, 194 B.R. 846 (Bankr. W.D. Mo. 1996); *Git-N-Go, Inc.*, 321 B.R. at 54; *I Shore*, 2004 WL 2357992 at * 3-7. In *American Energy Trading, Inc.*, the law firm at issue represented a creditor who obtained a judgment against the debtor. *American Energy Trading, Inc.*, 291 B.R. at 156. The trustee moved to retain this law firm to represent her in potential malpractice claims against debtor's former counsel in its handling of the lawsuit with the judgment creditor. *Id.* In finding that the law firm was disqualified, the bankruptcy court found:

> In this dual representation they are playing both sides, on one side advocating that the Debtor's defense in the underlying lawsuit was meritorious and would have succeeded but for the malpractice, while at the same time advocating to uphold the judgment against the Debtor on appeal. This dual representation is directly adverse to the Trustee and the bankruptcy estate. This type of schizophrenic representation violates the purpose of Section 327. [The law firm] cannot continue to serve both clients in what is essentially the same matter.

*Id.* at 157.

In *Perkey*, the trustee was prosecuting an adversary action against a bank to determine lien priority and to avoid a lien in certain commercial property. *Perkey*, 194 B.R. at 847. At the

same time, the bank was prosecuting an adversary action against the debtors based in part upon fraudulent transfers. *Id.* In both cases, the bank was represented by the same law firm. After determining that the bank did not have standing to pursue the fraudulent transfer action, the bankruptcy court allowed the trustee to intervene in the fraudulent transfer action, but did not allow the law firm to represent the trustee because it did not meet the requirements of Code § 327(a). In *Perkey*, the law firm was actively representing bank against the estate, while at the same time attempting to represent the estate in a fraudulent transfer action. In that case, the bankruptcy court prohibited the law firm from representing the trustee because the bank and the trustee were in direct conflict over the validity of the lien. *Id.* at 849-51.

In *Shore*, a respected Kansas law firm filed a petition for an individual debtor. On the same date the petition was filed, the law firm filed its employment application, which contained language that indicated that the law firm had no interest adverse to the debtor in any of the matters upon which its attorneys were to be engaged and that it was a disinterested party. *Shore*, 2004 WL 2357992 at *1. In addition to representing the debtor, the law firm represented debtor's non-filing spouse and a company which owed the debtor a significant amount of money on account of a lease. *Id.* at *2. Further, 50% of the company was indirectly owned by the children of the debtor and the non-filing spouse. *Id.* Such representations were not disclosed in the employment application.

The law firm took the position that the apparent conflicts of interest were more "theoretical" than real because essentially the company was the debtor's alter ego. Notwithstanding the same, the law firm also argued that the debtor's amended plan sought to reject the lease, and, as a result, any potential conflicts were moot. *Id.* at *3.

The bankruptcy court disagreed with the law firm. First, the court found that there was a clear conflict of interest. In deciding to pursue the amounts owed, the law firm would clearly have a choice to make. The law firm would have to decide whether to recommend to sue its other client and obtain approximately $179,000, which would then be paid to creditors. Alternatively, the law firm could recommend not to sue its other client, in which case the children of its third client (the wife) would be substantial beneficiaries of approximately 50% of the $179,000. *Id.* at *5.

Second, the court found that the fact that the lease was rejected did not rectify the problem. Indeed, the court questioned why the lease was not rejected immediately and that the

conflict was not eliminated because the plan could be amended again. *Id.* at *6. Finally, the court found that other conflicts of interest were apparent based upon the entangled financial affairs of the debtor, the wife, and the company. *Id.*

In short, the court found "that an attorney who represents both the debtor and also a creditor that results in any actual conflict ..., and who also represents a major debtor of that debtor ... by definition represents an interest adverse to the estate." *Id.* at *7. Accordingly, the court disqualified the law firm. Moreover, the court found independent basis for the disqualification on account that the law firm had not supplemented its disclosures reflecting its various representations. *Id.* at 8-9. Finally (and not unsurprisingly), the court rejected the argument that everything is going to turn out okay so the court is free to overlook the conflict. *Id.* at 8.

In *Git-N-Go, Inc.*, the law firm seeking to be retained as debtor's counsel in a Chapter 11 case also represented one of the debtor's largest creditors, which it had represented for decades. *Git-N-Go, Inc.*, 321 B.R. at 56-57. Additionally, the law firm represented another potential litigation target of the debtor. This potential litigation target represented 1% of the law firm's revenues for 2003. This representation was disclosed in the law firm's employment application. With respect to the litigation target, the bankruptcy estate sought to retain conflicts counsel. Additionally, the law firm obtained conflict waivers in certain instances. *Id.* at 57-58.

The bankruptcy court found that the law firm had manifest conflict loyalties, which could not be resolved by conflict waivers. *Id.* at 60. *See also American Energy Trading, Inc.*, 291 B.R. at 158. Further, the court found that the fact that a creditors' committee or special counsel may be appointed does not mitigate the potential issues of the conflicting loyalties to the extent that the debtor's relationship with the other client permeates every aspect of the case. *Git-N-Go, Inc.*, 321 B.R. at 61. In summary, the court found:

> While disqualification of the Debtor's preferred counsel is a harsh result, one the Court does not take lightly, the alternative is less appealing. The Bankruptcy Code provides that the Court may deny approval of compensation to the Debtor's professionals "if, at any time during such professional's employment under section 327 ..., such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed." 11 U.S.C. § 328(c). In light of the activity in this case and the amount of anticipated fees, the Court desires to avoid the possibility that counsel will not be paid for future work and to avoid the disruption and waste of resources that a later disqualification of counsel

> will cause. As [the attorney for the United States Trustee] stated in his closing argument, while the adversity between the Debtor and [the creditor] may not have fully ripened, the landscape resembles a minefield and the inevitable filing of bankruptcy by [the creditor] will create dueling fiduciaries and estates, in which counsel's advice to one fiduciary and estate will necessarily be at the expense of the other.
>
> The Court appreciates [the law firm's] forthright disclosures and willingness to accommodate the concerns of the Court, the United States Trustee and parties in interest. There is no question that [the law firm] sits in the unique position of possessing a wealth of knowledge about the Debtor, its financial condition, its business and its recent history, which will be impossible to fully replicate by substitute counsel. Additionally, the Court has no doubt about the experience and competence of counsel, or about counsel's good faith and honest desire to assist the Debtor toward a successful reorganization. Notwithstanding the advantages that [the law firm's] representation could offer to the estate, the Court concludes that [the law firm's] representation of interests adverse and potentially adverse to the estate preclude its employment as counsel for debtor in possession under Section 327(a).

*Id.* at 62. The lessons learned from these cases is that sometimes a conflict cannot be overcome. Notwithstanding the same, such conflicts or potential conflicts should always be fully disclosed. If disclosed and no party objects, it will be more difficult for a party to take issue with the employment later in the case.

## B. COMPENSATION ISSUES

### 1. Disclosure of Compensation

Section 329 requires that as part of the bankruptcy filing, that the debtor's attorney "file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation." 11 U.S.C. § 329(a). This disclosure is required to be submitted within 14 days after the order for relief is entered, which in a typical case will be the filing date. See FED. R. BANKR. P. 2016(b).

If such compensation is deemed unreasonable by the bankruptcy court, then the compensation agreement may be canceled or the attorney may be forced to disgorge such payment to the extent it is deemed excessive. 11 U.S.C. § 329(b). Further, courts have

consistently denied attorneys fees and require disgorgement for failure to make the required disclosures. *See, e.g., In re Redding*, 263 B.R. 874 (8th Cir. B.A.P. 2001).

**2. Post-Petition Fees**

In order for a bankruptcy to proceed in an orderly fashion, the Code generally provides that professionals' fees receive preferred status as an administrative priority. *See* 11 U.S.C. § 507(a). The tradeoff for this preferred status, however, is that a professional is required to seek court approval for its fees and expenses. *See* 11 U.S.C. § 330; FED. R. BANKR. P. 2002(a), 2016.

To obtain such approval, the professional will file either an interim or a final fee application. An interim fee application can generally be submitted every 120 days unless otherwise directed by the Court. *See* 11 U.S.C. § 331. A final fee application is generally filed at the end of the professional's engagement or the end of the case. Parties in interest have the right to object to the such applications and the Court can also reduce the compensation *sua sponte*. *See* 11 U.S.C. § 330(a)(2). The application shall contain the following information:

- statement of services rendered, time expended and expenses incurred;
- amounts requested;
- statement as to what payments have already been made or promised and the source of such payments;
- whether any compensation previously received has been shared and whether there is an agreement to share the same (except for sharing within the same firm)

FED. R. BANKR. P. 2016(a).

With respect to Chapter 7, if debtor's counsel seeks to be paid from the estate, then its counsel must be employed by the bankruptcy estate and such employment must be approved by the court. *See Lamie v. United States Trustee*, 540 U.S. 526, 538-39 (2004); *Redmond v. Clark (In re Wagers)*, 514 F.3d 1021, 1026 (10th Cir. 2007). In *Lamie*, the Supreme Court held:

> Under the Code's plain language, § 330(a)(1) does not authorize compensation awards to debtors' attorneys from estate funds, unless they are employed as authorized by § 327. If the attorney is to be paid from estate funds under § 330(a)(1) in a Chapter 7 case, he must be employed by the trustee and approved by the court.

*Lamie*, 540 U.S. at 526.

In *Wagers*, the debtors hired the law firm to represent them with respect to their financial situation. As a retainer, the debtors executed an assignment of their 2003 tax refunds, which amounted to $50,000. The debtor's incurred approximately $13,000 in post-petition legal fees. The law firm was never formally employed by the trustee or the bankruptcy estate. The trustee took the position that despite the law firm's assignment that the law firm was not entitled to any portion of the tax refund. *Wagers*, 514 F.3d at 1023-24. The Tenth Circuit, reversing the bankruptcy court, agreed:

> This Court shares the Bankruptcy Court's concerns regarding adequate payment of Debtors' counsel. However, we do not agree that the retainers in this case can properly be considered to be outside of the Debtors' estate. Whereas the Bankruptcy Court found that the Debtors retained only a contingent, reversionary interest in the retainer, we find it more likely that the Kansas Supreme Court would hold that it is the Firm that holds only a contingent interest in the funds. In any event, even a contingent, reversionary interest is included in a debtor's estate under § 541. Therefore, since the assigned tax refunds were property of the Debtors' estate, and the Firm was not employed by the Trustee pursuant to § 327, our decision is dictated by the United States Supreme Court's opinion in *Lamie*. We hold that the Firm may not use pre-petition funds to pay its post-petition fees under the circumstances of this case. The Bankruptcy Court's decision to the contrary is reversed.

*Id.* at 1029-30.

With respect to chapter 11, debtor's counsel is generally retained by the debtor-in-possession as one of the first pleadings filed with the bankruptcy court. If a Chapter 11 trustee, however, is appointed or the case is converted, counsel for the debtor should immediately seek to be employed by the trustee if they seek to be paid from the estate. Finally, a Debtor is required to provide information on what it has paid and agreed to pay counsel in the year prior to the Petition Date. 11 U.S.C. § 329; FED. R. BANKR. P. 2016. With respect to chapters 12 and 13, debtor's counsel does not need to be employed by the trustee to be compensated from the estate. *See* 11 U.S.C. § 330(a)(4)(B).

# DUE DILIGENCE: DUTIES OF ATTORNEYS REPRESENTING CONSUMER DEBTORS

# BAPCPA AMENDMENTS
# Section 707(b)(4)(C)

- (C) The signature of an attorney on a petition, pleading, or written motion shall constitute a certification that the attorney has--
- (i) performed a reasonable investigation into the circumstances that gave rise to the petition, pleading, or written motion; and
- (ii) determined that the petition, pleading, or written motion—
  - (I) is well grounded in fact; and
  - (II) is warranted by existing law or a good-faith argument for the extension, modification, or reversal of existing law and does not constitute an abuse under paragraph (1)

# Section 707(b)(4)(D)

- The signature of the attorney on the petition shall constitute a certification that the attorney has no knowledge after an inquiry that the information in the schedules filed with such petition is incorrect.

# DEBT RELIEF AGENCIES

- BAPCPA CREATED A NEW CATEGORY OF BANKRUPTCY SERVICER PROVIDERS CALLED "DEBT RELIEF AGENCIES"
- A "DEBT RELIEF AGENCY" IS ANY PERSON WHO PROVIDES ANY BANKRUPTCY ASSISTANCE TO AN ASSISTED PERSON IN RETURN FOR PAYMENT OF MONEY OR OTHER VALUABLE CONSIDERATON.

# DEBT RELIEF AGENCIES

- A Debt Relief Agency Shall Not:
  - Fail to perform a service it said it would provide. 526(a)(1)
  - Make an untrue or misleading statement. 526(a)(2)
  - Misrepresent any services that it will provide or the benefits and risks that may result if such person becomes a debtor. 526(a)(3).
  - Advise an assisted person to incur more debt in contemplation of filing. 526(a)(4).

# RECENT CASES

- Due Diligence and 707(b)(4) and Debt Relief Agency Provisions

# In Re Clink

- 2013 WL 1741945 (Bankr. W.D. Mo. 2013), aff'd 770 F.3d 719 (8th Cir. 2014).
- Debtor testified that she had discussed ownership of horses with her attorney several times and he had told her that she did not need to list them because "no one lists horses."
- Court found that attorney violated 707(b)(4) by failing to list the horses on schedules as either attorney knew of the horses and advised the debtor to not list them, or he unreasonably failed to ask debtor about any animal ownership.
- Court also found that attorney violated 707(b)(4)(C) by attaching to petition schedules that differed from schedules debtor had signed.

# In re Clink

- Court also found that attorney violated Debt relief agency provision by advising his client not to disclose a potential preferential transfer made to her mother.
- Bankruptcy court ordered disgorgement of all fees paid to him in amount of $1411; imposed sanctions against him of 3 times the amount of fees paid totaling $4233; and referred matter to District Court for disciplinary proceedings.
- Eighth Circuit affirmed and held that provision governing Debt Relief Agencies is violated when the agency advises any assisted person to make a fraudulent or misleading statement in a document in a bankruptcy case, regardless of whether the document containing the statement is then filed.

# In re Pigg

- 2015 WL 7424886 (Bankr. W.D. Mo. 2015).
- Two cases filed by same attorney were consolidated for hearing.
- In one of the cases, debtor had received tax refund of $10,355 within 90 days before filing. Debtor used tax refund to pay attorney, as well as pay $3654 for benefit of one of her mother's creditors, and $2000 to repay a loan to her sister. Debtor's attorney admitted that he knew about tax refunds and the payments to the family members before filing of petition, schedules, and statements and advised debtor not to disclose the transfers.
- Court concluded that debtor's attorney had violated 707(b)(4)(D) and issued civil penalty of $1500.

# In re Pigg

- In other case, debtor deposited over $8000 of insurance proceeds in her checking account two months before she filed and then shortly thereafter withdrew $5,000 in cash and put the cash in a lockbox in a safe at her employer's office. Debtor disclosed the cash to her attorney prior to filing of schedules but the existence of the $5,000 cash was not listed on schedules.
- Court held that fees were excessive under 329 due to attorney's failure to properly advise the debtor to file accurate schedules and promptly file amended schedules and ordered disgorgement of $600 in addition to $650 already disgorged.
- Court also found attorney violated 707(b)(4)(D) and issued civil penalty of triple his attorney fees for a total of $3750.
- Court referred matters to State Disciplinary Administrator.

# What constitutes a "Reasonable Investigation?

- How extensive and exhaustive must the pre-filing investigation be in order to protect the debtor and to ensure counsel comports with the expectations established by the amendments?

# In re Withrow

- 391 B.R. 217 (Bankr. D. Mass. 2008), aff'd 405 B.R. 505 (1st Cir. BAP 2009).
- Bankruptcy Court set forth 5 factors in considering whether Rule 9011(b) and 707(b)(4)(C) sanctions were appropriate.

# In re Withrow

- 1. Did Counsel impress upon the debtor the critical importance of accuracy in the preparation of documents to be presented to the court?
- 2. Did the attorney seek from the debtor and then review whatever documents were with the debtor's possession, custody or control in order to verify the information?
- 3. Did counsel "employ such external verification tools as were available and are not time or cost prohibitive (e.g. online real estate title records; online lien searches; online automobile title records.

# In re Withrow

- 4. Was any of the information provided by the debtor and then set forth in the debtor's court filings internally inconsistent – was there anything that should have obviously alerted the attorney that the information provided by the debtor could not be accurate?

- 5. Did the attorney act promptly to correct any information presented to the Court, which turned out, notwithstanding the attorney's best efforts, to be inaccurate.

# In re Withrow

- First Circuit BAP affirmed Withrow, and held that debtor's counsel had an affirmative duty to conduct a reasonable inquiry into the facts set forth in the debtor's schedules and statement of financial affairs before filing them. Counsel's signature on the pleadings and schedules operates as a certification regarding the representations contained therein but that certification is not an absolute guaranty of accuracy.

# In re Withrow

- Withrow decision suggests that it is reasonable to rely on the debtor's representations when there is no other reasonable means by which to obtain the information. However, the mere reliance without corroborating information when such information is readily available or customarily obtained will not shield an attorney from Rule 9011 or 707(b)(4)(C) sanctions.

# Fee Disclosures

- 11 USC 329(a) – any attorney representing a debtor shall file with the court a statement of the compensation paid or agreed to be paid, if such payment was made within one year prior to filing for services rendered in connection with case and the source of such compensation.
- Fed. R. Bank. P. 2016(b) – statement disclosing fees shall be filed within 14 days after order for relief.
- Disclosure requirements are mandatory. The purpose of the disclosure is to allow any party an interest to make an independent judgment about the effect on the estate of any given payment.
- Court may deny all attorney fees for failing to meet the disclosure requirements of section 329.

# Recent Decision on Fee Disclosure and Other Sanctions

- In re Miller Automotive Group, 521 BR 323 (Bankr. WD MO 2014), aff'd 536 B.R. 828 (8th Cir. BAP 2015).
- BAP affirmed Bankruptcy Court's decision to impose sanctions including disgorgement of fees and indefinite suspension from practice of law.
- Bankruptcy court made following findings:
  - Attorney failed to inform his client about pleadings he filed including application to employ broker he had pre-existing business relationship with;
  - Attorney failed to obtain his client's input and authorization before filing motions and pleadings.
  - Attorney failed to perform reasonable investigation into facts contained in petition and made other filings without conducting due diligence.
  - Attorney failed to enter into written fee agreement with client and misled client's principals as to total amount they would have to pay.
  - Attorney intentionally obscured the true source of retainer .
  - Attorney failed to comply with local rules regarding electronic filing including failing to obtain and retain original signatures on filings in the case.

# Duty of Attorney to Personally Meet with Client

- In re Sledge, 352 BR 742 (Bankr. E.D. N.C. 2006) – Professional standard of care imposed on attorneys representing debtors requires attorney to personally meet with each debtor-client, and to review petition with debtor prior to filing to ensure correctness of information and debtor's comprehension of consequences of filing bankruptcy. It is not enough for debtor to meet only with paralegal.
- Court ordered attorney to disgorge fees paid and also pay attorney fees to attorney who filed motion for disgorgement.

# Duty of Attorney to Meet with Client

- In re Pinkins, 213 BR 818 (Bankr. E.D. Mich. 2006)
- High volume law firm's legal assistants engaged in the unauthorized practice of law when attorneys did not meet with clients until after case was filed.

**LEO 1883:**

## ETHICAL OBLIGATIONS OF A LAWYER FOR A CHAPTER 7 BANKRUPTCY PETITIONER IN HANDLING FIXED FEES ADVANCED BY THE CLIENT

This opinion provides guidance to attorneys who face the conflict between the ethical obligation to maintain unearned legal fees advanced by a client[1] in an attorney trust account and the application of bankruptcy law which would render fees in trust an asset of the petitioner's bankruptcy estate and unavailable to the attorney or the client at the time a Chapter 7 petition is filed.

### QUESTION PRESENTED:

May a debtor's attorney withdraw from his trust account the balance of his client's advance of a fixed legal fee immediately before filing the client's Chapter 7 petition in bankruptcy when there remain post-petition legal services that are incomplete or have yet to be performed?

### APPLICABLE RULE OF PROFESSIONAL CONDUCT:

Rules of Professional Conduct 1.15(a)(1) and 1.15(b)(4)[2] apply to the issue presented in this opinion.

### ISSUE PRESENTED:

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[1] This opinion does not address, and is not intended to apply to, those instances when a bankruptcy petitioner's legal fees are paid by a third party, when legal fees are structured so as to be payable by a debtor from post-petition income, if permissible, or when substantial post-petition legal services are involved. The opinion is intended to address the ethical dilemma occasioned when the bankruptcy lawyer accepts his full fixed fee directly from the client in advance of his filing the client's Chapter 7 bankruptcy petition.

[2] **RULE 1.15 Safekeeping Property**

(a) Depositing Funds.

(1) All funds received or held by a lawyer or law firm on behalf of a client or a third party, or held by a lawyer as a fiduciary, other than reimbursement of advances for costs and expenses shall be deposited in one or more identifiable trust accounts; all other property held on behalf of a client should be placed in a safe deposit box or other place of safekeeping as soon as practicable.

(b) Specific Duties. A lawyer shall:

(4) promptly pay or deliver to the client or another as requested by such person the funds, securities, or other properties in the possession of the lawyer that such person is entitled to receive[.]

According to the National Association of Bankruptcy Trustees, "[i]n approximately 90% of the Chapter 7 bankruptcy cases filed, there are no assets available for liquidation, either because assets are exempt (protected) by debtors or liened by secured creditors."[3] Lawyers who handle Chapter 7 bankruptcy cases for debtors normally charge fixed fees for their services. Those fees are intended to cover both pre-petition and post-petition legal services, which end when the client obtains his bankruptcy discharge.

Under current bankruptcy law, an estate is created when a voluntary bankruptcy petition is filed, and fees advanced to his attorney by a Chapter 7 debtor which remain in trust upon the filing of a petition become the property of the bankruptcy estate under 11 U.S.C. §541. Interpreting 11 U.S.C. §330(a)(1) [4], the United States Supreme Court in *Lamie v. United States Trustee,* 540 U.S. 526, 124 S.Ct. 1023, 157 L.Ed.2d 1024 (2004) held that unless the debtor's attorney has been hired by the bankruptcy trustee in a Chapter 7 case, the debtor's attorney cannot be paid from the assets of the bankruptcy estate.

This being so, the very purpose of the attorney's fixed fee being secured by its collection before legal services are performed is undermined if the unearned portion of those fees, remaining in the attorney's trust account, cannot be applied to the attorney's credit once the client's petition has been filed. Compounding this problem is the conflict of interest[5] that might arise between the

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[3] See website entry at http://www.nabt.com/faq.cfm#Q1

[4] **§330. Compensation of officers**

(a)(1) After notice to the parties in interest and the United States Trustee and a hearing, and subject to sections 326, 328, and 329, the court may award to a trustee, a consumer privacy ombudsman appointed under section 332, an examiner, an ombudsman appointed under section 333, or a professional person employed under section 327 or 1103—

(A) reasonable compensation for actual, necessary services rendered by the trustee, examiner, ombudsman, professional person, or attorney and by any paraprofessional person employed by any such person; and

(B) reimbursement for actual, necessary expenses.

[5] *See,* Rule of Professional Conduct 1.7(a)(2):

**RULE 1.7 Conflict of Interest: General Rule.**

(a) 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:

> (2) there is 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.

bankruptcy attorney and his client were the balance of the unearned fee to be listed as a debt on the client's bankruptcy petition: It would be in the client's interest to have this debt to the attorney discharged, along with all other debts which the attorney is assisting the client in having discharged. Alternatively, were the attorney to be paid from a fee advance remaining in trust following the Chapter 7 bankruptcy filing available by resort to the debtor's Virginia homestead exemption, the sum so paid would reduce the debtor's exemption, to his detriment. An attorney who advises his client to use the client's homestead exemption to pay the lawyer's fee under these circumstances would have a conflict of interest.

Rule of Professional Conduct 1.15(a)(1) requires that fees collected in advance of the provision of legal services be placed in a trust account. An attorney may not apply to his credit any portion of a legal fee which has not been earned. Compendium Legal Ethics Opinion 1606, issued in 1994 when the Code of Professional Responsibility was in force, remains a vital resource for guidance on how legal fees are to be handled under the successor provisions of the Rules of Professional Conduct. The Opinion defines "advanced legal fees" and how they are to be handled as follows:

> Advanced Legal Fees. Fees paid in advance for particular legal services not yet performed are advanced legal fees regardless of the terminology used in the employment contract. Advanced legal fees are not violative of the Disciplinary Rules as long as they are properly deposited and identified as belonging to the client until earned. The Committee has consistently opined that the element of payment for future legal services differentiates advanced legal fees from a retainer. LE Op. 1322, LE Op. 1178. The two terms are not synonymous.
>
> Because advanced legal fees do not belong to the lawyer until the services are rendered, it is the opinion of the Committee that they must be deposited in an identifiable account (trust account) and remain the property of the client until they are earned by the attorney. The Committee notes that in some situations, the employment contract may provide that a portion of an advanced legal fee is considered to be earned at the time it is paid. In this case the earned portion becomes the property of the lawyer and may not be deposited in the lawyer's trust account.
>
> Upon termination of the representation it is the duty of the attorney to refund any portion of an advanced legal fee which has not been earned. In addition, all fees charged against the account must be reasonable and must be adequately explained to the client. ***

The term "fixed fee" is defined in the Opinion :

> Fixed Fee. The term fixed fee is used to designate a sum certain charged by a lawyer to complete a specific legal task. Because this type of fee arrangement provides the client with a degree of certainty as to the cost of legal services, it is to be encouraged.
>
> **A fixed fee is an advanced legal fee. It remains the property of the client until it is actually earned and must be deposited in the attorney's trust account.** If the representation is ended by the client, even if such termination is without cause and constitutes a breach of the contract, the client is entitled to a refund of that portion of the fee that has not been earned by the lawyer at the time of the termination. LE Op. 681. In such circumstances, what portion of the fee has been earned requires a *quantum meruit* determination of the value of the lawyer's services in accordance with *Heinzman* and *County of Campbell v. Howard*, 133 Va. 19 (1922). [Emphasis supplied.]

**ANALYSIS:**

Given the dilemma presented by the tension between the lawyer's ethical obligation to retain unearned fees in trust and the legal effect of having those same fees revert to the bankruptcy estate under 11 U.S.C. §541 when a bankruptcy petition is filed, what is an attorney to do? One might also ask, how *have* attorneys been handling fees under these circumstances?

The Committee has learned from practitioners that three methods of handling advanced, fixed fees, for Chapter 7 bankruptcy cases are being employed. Lawyers are

1. treating advanced fees as "earned when paid" and are applying them upon receipt to the lawyer's credit;
2. withdrawing the balance of all fees remaining in their trust accounts at the time the client's Chapter 7 bankruptcy is concluded; or
3. withdrawing the balance of all fees remaining in their trust accounts immediately before the Chapter 7 petition is filed on behalf of the client.

Method 1 is as ethically impermissible in connection with a Chapter 7 bankruptcy case as it would be in any other legal matter. Such money handling by the lawyer violates Rule 1.15(a)(1) and the precepts of LEO 1606. No client funds should be applied to the lawyer's credit, when tendered, for legal services which have yet to be performed. In the event the lawyer becomes disabled, dies, is discharged by the client, terminates representation of the client, or has his license to practice suspended or revoked, any unearned legal fees, which remain the property of the client, must be in a trust account, and thus on hand for return to the client.

Method 2 is unacceptable because the lawyer would be applying an asset of the bankruptcy estate created by 11 U.S.C. §541 to his own credit in contravention of 11 U.S.C. §330(a)(1), as interpreted by the United States Supreme Court in *Lamie v. United States Trustee, supra*.

Method 3 is an ethically permissible practice available to attorneys handling Chapter 7 bankruptcies for debtors at this time for the reasons stated below.

The Chapter 7 debtor's attorney has no discretion to treat unearned fees on hand in his trust account as either potentially his or the client's once the bankruptcy petition has been filed. The only proper "trustee" of such funds would be the Chapter 7 bankruptcy trustee, who superintends the disposition of the bankruptcy estate. Once the Chapter 7 bankruptcy petition is filed, funds on hand in an attorney's trust account under Rule 1.15(a)(1) are no longer either the property of the client or potentially the property of the lawyer. Bankruptcy law pre-empts the lawyer's authority to dispose of the funds in any manner other than to surrender them to the trustee upon request pursuant to Rule 1.15(b)(4). Therefore, once the Chapter 7 petition has been filed, the lawyer cannot dispose of that portion of the bankruptcy estate in his possession by applying funds in trust to his own credit or by remitting those funds to the client. The bankruptcy attorney has become, in a sense, the bankruptcy trustee's trustee.

The debtor's attorney's fee disclosure form used in Chapter 7 bankruptcy cases does not require an accounting of and how and when fees paid before a petition was filed were or are to be applied to the attorney's credit. The form merely requires an identification of the total fees charged, the sum already paid (with no reference to "earned"), and the balance due.[6]

It is thus the case that the court, the creditors, and the bankruptcy trustee are not systematically informed of the manner in which the attorney has disposed of, or intends to dispose of, the advanced fee paid to him, and whether any portion thereof remains in a trust account as of the time the bankruptcy petition was filed. The Committee is advised that as long as the fee listed on the disclosure form is reasonable, it typically remains unchallenged by creditors and the

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[6] In pertinent part, the form reads as follows:

**DISCLOSURE OF COMPENSATION OF ATTORNEY FOR DEBTOR**

1. Pursuant to 11 U.S.C. § 329(a) and Fed. Bankr. P. 2016(b), I certify that I am the attorney f or the above- named debtor(s) and that compensation paid to me within one year before the filing of the petition in bankruptcy, or agreed to be paid to me, for services rendered or to be rendered on behalf of the debtor(s) in contemplation of or in connection with the bankruptcy case is as follows:

For legal services, I have agreed to accept . . . . . $_____

Prior to the filing of this statement I have received . . . . . .$_____

Balance Due . . . . . $_____

bankruptcy trustee. The ethical question of how an advanced, fixed fee must be handled is not, however, addressed either by substantive bankruptcy law or by the bankruptcy rules of procedure.

For these reasons, the Committee believes that a lawyer who received advanced, fixed fees tendered by a client for a Chapter 7 case may ethically withdraw the balance of all fees remaining in his trust account immediately before the Chapter 7 petition is filed on behalf of the client.

Representing a client in a Chapter 7 bankruptcy typically consists of these basic tasks (described, in part, in the disclosure form referred to above):

1. Analyzing the debtor' s financial situation, and rendering advice to the debtor as to whether a bankruptcy petition should be filed;

2. Preparing the petition (including schedules, and a statement of affairs);

3. Filing the petition; and

4. Representing the debtor at the meeting of creditors.

Typically, in Chapter 7 bankruptcies, the time consumed by the legal services is predominantly devoted to the attorney's accomplishing tasks 1 and 2 above. Attending a meeting of creditors is typically routine in nature and not time consuming—especially when an attorney is able to make a single appearance on behalf of multiple clients such that the attorney's travel and waiting time devoted to each matter can be prorated.

It is thus the case that the fixed fee paid to the attorney at the inception of the representation in a Chapter 7 bankruptcy matter has been largely earned as of the time that the petition is filed. The Committee believes that under these circumstances, an attorney's fee agreement with the client may identify the filing of the bankruptcy petition as a reasonable "benchmark"[7] for distribution

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[7] *See,* "Frequently Asked Question" No. 22 contained on the Virginia State Bar's website:

**22. Flat Fees**

**When is a flat/fixed fee considered earned? What happens if the attorney's representation is terminated before the representation is complete?**

Unless the fee agreement specifies otherwise, the entire flat fee is unearned and must remain in the trust account until the entire representation is complete. If the representation is terminated before the matter is complete, the attorney is entitled to a fee based on quantum meruit for the work done prior to termination.

**The fee agreement may provide for certain portions of the flat fee to be earned upon the completion of certain benchmarks, which would allow the attorney to draw down the flat fee in stages throughout the representation rather than earning the full fee at the conclusion of the matter. The**

to the attorney of the balance of the advanced, fixed fee, which remains in the attorney's trust account at that time. The disbursement made by the attorney from his trust account would eliminate both the problem of having that small portion of the advanced fee intended to cover the creditors' meeting become a part of the bankruptcy estate and the need to have the attorney himself listed in the bankruptcy petition as a creditor of his client.

Such a benchmark is entirely reasonable and consistent with the protection of client assets envisioned in Rule 1.15(a)(1) and LEO 1606 because bankruptcy courts, once a petition has been filed, have the authority to examine a debtor's transactions with his attorney and to order disgorgement of excessive fees under 11 U.S.C. § 329(a) and (b).[8] This is a remedy available to the debtor (and others) in a bankruptcy matter different than, and independent from, the traditional civil procedure in a state or federal court which would require proof by the client that he is entitled to a judgment against his attorney for having charged excessive fees. Thus, a bankruptcy court which determines that a debtor's attorney has failed to perform the services for which he was engaged may be ordered to "disgorge" fees from the attorney's own assets—and not from the bankruptcy estate—for refund to the disadvantaged debtor/client. This remedy provides ample protection to a client whose advanced fees, if there remained any in his attorney's trust account, would not then be the property of the attorney or the client, in any event.

**CONCLUSION:**

An attorney may ethically disburse from his trust account, to his own credit, the entirety of the advanced fixed fees tendered by the client and remaining in his attorney trust account immediately before he files the client's Chapter 7 bankruptcy petition. Disbursement at that time avoids the sum in trust becoming a part of the bankruptcy estate, and eliminates the conflict of interest which would apply in the face of a need to have an outstanding indebtedness to the attorney listed on the client's bankruptcy petition. The attorney has already performed most of the work associated with the client's matter as of the time a petition is filed, and it is a reasonable benchmark in a fixed-fee agreement to have the balance of fees disbursable immediately before the petition is filed. The client is assured protection in the event his lawyer fails to perform post-petition legal services fully and competently because the bankruptcy court is authorized to order the attorney to disgorge excessive fees and refund them to the client.

This opinion is advisory only and not binding on any court or tribunal.

Committee Opinion
July 23, 2015

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**fee earned at each benchmark must be reasonable considering the amount of work completed.** [Emphasis is supplied.]

[8] For an excellent discussion and exercise of this authority in a Chapter 7 bankruptcy matter, see *In re Harwell*, 439 B.R. 455 (Bankr. W.D. Mich., 2010).

# AMERICAN BAR ASSOCIATION

STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

**Formal Opinion 11-461** **August 4, 2011**

**Advising Clients Regarding Direct Contacts with Represented Persons**

*Parties to a legal matter have the right to communicate directly with each other. A lawyer may advise a client of that right and may assist the client regarding the substance of any proposed communication. The lawyer's assistance need not be prompted by a request from the client. Such assistance may not, however, result in overreaching by the lawyer.*[1]

A lawyer may not communicate with a person the lawyer knows is represented by counsel, unless that person's counsel has consented to the communication or the communication is authorized by law or court order. ABA Model Rule 4.2 (sometimes called the "no contact" rule). Further, a lawyer may not use an intermediary, i.e., an agent or another, to communicate directly with a represented person in violation of the "no contact" rule.[2]

It sometimes is desirable for parties to a litigation or transactional matter to communicate directly with each other even though they are represented by counsel. Two examples may be where the parties wish to cement a settlement or break an impasse in settlement negotiations. In this opinion, the Committee explores the limits within which it is ethically proper under the Model Rules of Professional Conduct for a lawyer to assist a client regarding communications the client has a right to have with a person the lawyer knows is represented by counsel. Even though parties to a matter are represented by counsel, they have the right to communicate directly with each other.[3] In addition, a client may require the lawyer's assistance and a lawyer may be reasonably expected to advise or assist the client regarding communications the client desires to have with a represented person. A client may ask the lawyer for advice on whether the client may lawfully communicate directly with a represented person without their lawyer's consent or their lawyer being present. The comments to Rules 4.2 and 8.4(a) state that such advice is proper.[4] Even if the client has not asked for the advice, the lawyer may take the initiative and advise the client that it may be desirable at a particular time for the client to communicate directly with the other party.

For example, a lawyer represents a client in a marital dissolution. The client's husband also is represented by counsel. The parties and their lawyers have reached an impasse in their negotiations over various issues. The client may ask her lawyer if she may communicate directly with her husband to see if an agreement can be reached on some contested issues. Alternatively, the lawyer might independently

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[1] This opinion is based on the ABA Model Rules of Professional Conduct as amended by the ABA House of Delegates through August 2011. The laws, court rules, regulations, rules of professional conduct, and opinions promulgated in individual jurisdictions are controlling.

[2] Rule 8.4(a). The Rule states: "[i]t is professional misconduct for a lawyer to violate or attempt to violate the Rules of Professional Conduct, knowingly assist or induce another to do so, or do so through the acts of another." ABA Comm. on Ethics and Professional Responsibility, Formal Op. 95-395 (1995) ("Since a lawyer is barred under Rule 4.2 from communicating with a represented party about the subject of the representation, she [under Rule 8.4(a)] may not circumvent the Rule by sending an investigator to do on her behalf that which she is herself forbidden to do."); ANNOTATED MODEL RULES OF PROFESSIONAL CONDUCT 408 (ABA 7th ed. 2011) ("A lawyer may not, however, "mastermind" a client's communication with a represented person.").

[3] *See* Holdren v. General Motors Corp., 13 F.Supp.2d 1192, 1195 (D. Kan. 1998) ("there is nothing in the disciplinary rules which restrict a client's right to act independently in initiating communications with the other side, or which requires that lawyers prevent or attempt to discourage such conduct." (citing New York City Bar Association Formal Opinion No.1991-2, at 5-6)); Dorsey v. Home Depot U.S.A., Inc., 271 F.Supp.2d 726, 730 (D.Md.2003) ("Nothing in the law prohibits litigants or potential litigants from speaking among and between themselves, as opposed to attorneys for such parties attempting direct communications with represented parties."); Northwest Bypass v. U.S. Army Corps of Engineers, 488 F.Supp.2d 22, 28-29 (D.N.H. 2007) (not improper for represented party to communicate directly with represented opponent).

[4] *See* Rule 4.2 cmt. 4 ("A lawyer may not make a communication prohibited by this Rule through the acts of another. *See also* Rule 8.4(a) cmt. 1 ("Lawyers are subject to discipline when they violate or attempt to violate the Rules of Professional Conduct, knowingly assist or induce another to do so or do so through the acts of another, as when they request or instruct an agent to do so on the lawyer's behalf. Paragraph (a), however, does not prohibit a lawyer from advising a client concerning action the client is legally entitled to take.").