Understanding the Ethical Limits: Retention Issues

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Understanding the Ethical Limits – Retention Issues Classic Conflicts Problems

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Chapter 11

1. Disinterestedness/Lack of Adverse Interest and Professional Conduct Rules

Bankruptcy Code § 327(a) requires that professionals for the trustee (and debtor in possession) be disinterested and not hold or represent an interest adverse to the estate. "Disinterestedness" includes a checklist of attributes that entail the professional not holding a conflicting interest, such as being a creditor. 11 U.S.C. § 101(14). "Adverse interest" has been defined broadly to mean either (1) possessing or asserting any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate would be a rival claimant, or (2) possessing or having a predisposition under the circumstances to be biased against the estate. *E.g. In re American Intern. Refinery, Inc.*, 676 F.3d 455 (5th Cir. 2012).

Model Rule of Professional Conduct ("Model Rule") 1.7 provides that a lawyer shall not represent a client if (a) the representation will be directly adverse to another client or (b) there is a significant risk that the representation will be materially limited by the lawyer's responsibilities to another client, former client or third person, unless (1) the lawyer reasonably believes the representation will not adversely affect the relationship, and (2) each client consents after

consultation, which shall include an explanation of the implications of common representation and the advantages and risks involved. *See also* RESTATEMENT THIRD, THE LAW GOVERNING LAWYERS § 128.

Professional Conduct Rules with respect to former clients, entity clients and conflict waivers also bear regularly on conflicts in bankruptcy cases. *See* Model Rules 1.9, 1.13, 1.0(e). When the clients who are to give informed consent to conflict waivers are debtors, the court may determine that the client should not agree to the waiver under the circumstances, taking into account the interests of the debtor's estate as a whole. *See In re Congoleum Corp*., 426 F.3d 675 (3d Cir. 2005) (waiver inadequate due to lack of informed consent); *In re JMK Construction Group, Ltd*., 441 B.R. 222, (Bankr. S.D. N.Y. 2010) (waiver requires court approval).

2. Representation of Multiple Debtors

Affiliated debtors tend to have claims against each other, e.g. for intercompany indebtedness or guarantees; it may be in the interest of one debtor to collect for its creditors, and in the interest of the other to contest or delay payment. One debtor may be a "cash drain" while another is a relative "cash cow," and one may have a different creditor body than the other placing counsel for both in the cross-hairs of representing the interests of each one competently, taking into account their fiduciary duties to their respective creditors.

Disqualification of counsel for multiple debtors appears to be more likely in cases of closely held corporations or partnerships and their principals, perhaps because of more inside and outside professionals' involvement in larger cases. *See In re Straughn*, 428 B.R. 618 (Bankr. W.D. Pa. 2010) and cases cited therein.

Concerns that joint counsel for related debtors might not vigorously pursue claims of one against the other may also be addressed through hiring special counsel to evaluate and pursue inter-estate claims, or employing an examiner to evaluate them. In the *Adelphia* case, the multiple debtors and their counsel established a court-approved procedure to litigate inter-estate disputes in a fashion that gave affected creditors a fair and full opportunity to press their

positions. *In re Adelphia Communications Corp*., 336 B.R. 610 (Bankr. S.D. N.Y.), aff'd, 342 B.R. 122 (S.D.N.Y. 2006). This procedure was important to the bankruptcy court's decision not to disqualify counsel for the multiple debtors from representation. The court also directed that DIP counsel act as a neutral facilitator, not an advocate, in inter-estate disputes.

3. DIP Counsel's Connections with DIP Management

Debtors in possession, like trustees, owe fiduciary duties to their estate constituents. DIP management is not required to be disinterested, may have its own agenda and conflicting interests, and may require significant guidance in understanding how to comply with fiduciary duties. *See* "Duties of Counsel for a DIP as Fiduciary and Responsibilities to the Estate," Lupica and Rapoport, Co-Reporters, Final Report of the ABI National Ethics Task Force ("Ethics Task Force Report") at 11-27 (2013). At the retention stage of the case, the court may disqualify professionals when their connections with management or equity may incentivize them to be more loyal to those persons than to the debtor entity and its estate, a personal conflict of interest. *See In re Occidental Financial Group, Inc.*, 40 F.3d 1059 (9th Cir. 1994).

4. Representation of Creditors; Client Waivers

A professional is not disqualified as DIP counsel solely because of employment by a creditor, absent objection by another creditor or the U.S. Trustee, and a finding by the court that an actual conflict of interest exists. 11 U.S.C. § 327(c).

Litigating a claim objection or avoidance action against a firm client would be "directly adverse" in the words of Model Rule 1.7, and thus result in a conflict of interest. It is more problematic whether that categorization applies to forcing contract compliance pending assumption/rejection or resisting a prompt decision on assumption/rejection or merely filing the Chapter 11 petition. The determination is objective, and turns on whether such action will have a substantial impact on the other firm client, e.g. by staying pending litigation, or preventing contract termination or a suit that would otherwise be brought given the amount involved. In a single-asset bankruptcy case, the mere filing of a petition is undoubtedly "directly adverse" to

the secured lender. In a Chapter 11 of an operating business, merely filing the case is likely not directly adverse to small creditors and parties in interest.

In determining the second conflict test of Model Rule 1.7, whether there is a significant risk that representation of the DIP will be materially limited by responsibilities to another client, the test is subjective, and focuses on the impact on counsel's decision-making – e.g. will it affect evaluation of whether to switch to another contract supplier, and whether to file preference litigation? The materiality of any limitation is also affected by how pervasive the creditor's role is in the case and how important the creditor is to the law firm. *See, e.g. In re Project Orange Associates, LLC*, 431 B.R. 363 (Bankr. S.D. N.Y. 2010) (representation on other matters of largest creditor, central to reorganization, and whose waiver still forbid bringing or threatening any actions, disqualified DIP counsel); *In re Premier Farms, L.C.*, 305 B.R. 717 (Bankr. N.D. Iowa 2003) (current representation of secured creditor disqualifying even though its work was less than 1% of firm's billings, due to perceived or actual bias favoring long-term bank client over one-time DIP); *In re Amdura Corp.*, 121 B.R. 862 (Bankr. D. Colo. 1990) (largest creditor in the case was a significant client of the firm: "the hand that feeds the firm").

When the conflict is not central to the case and the subjective risk of material adverse impact on counsel's representation is resolved, the issue of direct adversity may be addressed through limitations on the scope of representation of the DIP, including through special counsel to handle any matters considered directly adverse to the creditor client. *See* "The Use of Conflicts Counsel in Business Reorganization Cases," Ethics Task Force Report at 37-47.

The terms of a waiver agreement with a creditor client (on unrelated matters) and the DIP should be clear on the scope of the waiver. For example, they could ethically agree that the firm would not represent the DIP on matters directly adverse to the creditor, and that objecting to the creditor client's proof of claim, or filing any adversary proceeding against it would be deemed direct adversity, while plan treatment of the claim would not be deemed directly adverse. They could agree that negotiating terms for and seeking to assume the creditor client's contract would not be considered direct adversity, while a motion to reject that contract would be deemed

directly adverse. Any such limitation must be spelled out, and disclosed to the court. In the *Jore* case, DIP counsel agreed with the DIP lender, a client on unrelated matters, not to litigate against the lender, without disclosing the no-litigation carve-out from the waiver to the court. When a dispute over ability to impose a Section 506(c) surcharge arose, the lender considered that to be prohibited litigation within the scope of the waiver carve-out. *In re Jore Corp*., 298 B.R. 703 (Bankr. D. Mont. 2003).

This is not only an issue for the bankruptcy court; state courts may decide client claims of professional misconduct and conflicts on the part of their lawyers. *Matter of Breen*, 171 Ariz. 250, 830 P.2d 462 (1992) (§ 327(c) does not release an attorney from state law ethical requirements; attorney sanctioned an attorney for filing a bankruptcy case for one client adverse to a former client creditor).

5. Fee-Based Conflicts

If a professional is a creditor on account of prepetition work, the disinterestedness requirement generally disqualifies the professional, unless fees are waived. *See U.S. Trustee v. Price Waterhouse*, 19 F.3d 138 (3d Cir. 1994); *see also In re SBMC Healthcare, LLC*, 473 B.R. 871 (Bankr. S.D. Tex. 2012) (claim waived against debtor but not against insider guarantor). A few courts have authorized alternatives to waiver of the fee claim. A sale of the fee claim, even to an affiliate of the debtor, may suffice to cure disinterestedness if the attorney retains no financial interest in the estate, direct or indirect. *See In re 7677 East Berry Ave. Associates, L.P.*, 419 B.R. 833 (Bankr. D. Colo. 2009) (sale to affiliated non-debtor entity with sufficient assets to pay purchase price prevented disqualification as creditor); *see also In re SBMC Healthcare, LLC*, 473 B.R. 871 (Bankr. S.D. Tex. 2012) (employment as special counsel approved on specified conditions).

Potential avoidance action exposure for prepetition payments before bankruptcy may also result in the professional holding a disqualifying conflict of interest. *See In re Pillowtex, Inc*., 304 F.3d 246 (3d Cir. 2002) (when facially plausible preference claim, court cannot approve

retention conditioned on later refund if preference later proven). General allegations without a facially plausible claim of a preference has been held not disqualifying when counsel commits to investigate all preferences and a committee exists to monitor the action. *See In re 7677 East Berry Ave. Associates, L.P.*, 419 B.R. 833 (Bankr. D. Colo. 2009).

When the debtor lacks sufficient funds to pay a retainer, the professional may seek compensation or a fee guarantee from an insider, creditor, or other party interested in a successful reorganization case. Payment of fees by third parties is expressly sanctioned by the Model Rules, as long as client consent is obtained, client confidentiality protected, and no interference is imposed on the lawyer's independent professional judgment or lawyer-client relationship. Model Rule 1.8(f); comment to Model Rule 1.7.

However, some courts have refused to approve or have terminated counsel's representation because of the appearance of conflict and potential for conflict when the motives of the retainer payor are suspect in light of creditor status and other entanglements with the estate. They note that fee payment from sources other than the debtor may subject counsel to the temptation of furthering the payor's interests and deviating from the duty of undivided loyalty to the real client. *See In re Crimson Investments, N.V.*, 109 B.R. 397 (Bankr. D. Ariz. 1989) (retainer from insider/creditor); *In re Moore*, 470 B.R. 414 (Bankr. N.D. Tex. 2012), subsequently rev'd, 739 F.3d 724 (5th Cir. 2014) (creditor defendant paid trustee's special litigation counsel's fees without disclosure; adversity between creditor and trustee illustrates conflicts that can arise). Some courts have flatly held that any fee payment by a third party is an actual conflict of interest disqualifying a professional from employment "absent a showing that the interests of the third party and the bankruptcy estate are identical" upon notice to all parties. *See In re Hathaway Ranch Partnership*, 116 B.R. 208 (Bankr. C.D. Cal. 1990).

6. Positional Conflicts

The American Bar Association has defined the question of positional or issue conflicts as "whether a lawyer can represent a client with respect to a substantive legal issue when the lawyer knows that the client's position on that issue is directly contrary to the position being urged by

the lawyer (or the lawyer's firm) on behalf of another client in a different, and unrelated pending matter." ABA Comm. On Ethics and Prof'l Responsibility, Formal Op. 93-377 at 1 (1993).

On the topic of multiple representations, Rule 1.7 of the Model Rules of Professional Conduct provides:

> (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: (1) the representation of one client will be directly adverse to another client; or (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third party or by a personal interest of the lawyer. (b) Notwithstanding the existence of a concurrent conflict of interest in paragraph (a), a lawyer may represent a client if: (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client; (2) the representation is not prohibited by law; (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and (4) each affected client gives informed consent, confirmed in writing.

It is easy to imagine a situation where a lawyer is approached by more than one party in a bankruptcy case for representation; it happens quite often. A bankruptcy case, however, is not the same as traditional litigation in that all parties in a bankruptcy proceeding have some *potential* for adversity. Often times, a conflict that arises when representing two entities in a bankruptcy proceeding are issue specific, and when the isolated issue is resolved, the conflict goes away.

While much of the Model Rules seem to have been drafted with without bankruptcy in mind, Comment 3 to the Rule speaks to a scenario in which a lawyer or firm might represent multiple parties in a bankruptcy, providing that "simultaneous representation in unrelated matters of clients whose interests are only generally adverse, such as competing economic enterprises, does not require consent of the respective clients. Paragraph (a) [of Rule 1.7] applies only when the representation of one client would be *directly adverse* to the other." (emphasis provided). Furthermore, 11 U.S.C. §327(a) provides "[e]xcept as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers,

auctioneers, or other professional persons, *that do not hold or represent an interest adverse to the estate*, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title." This implies that an actual, current conflict must be present to disqualify the dual representations.

There is very little case law on the issue of positional conflicts generally, and less with respect to the issue arising in a bankruptcy proceeding. One would hope that this is because cautious lawyers take the proper steps to avoid trouble. In the situation of positional couflict, where disqualification and or sanctions could result from not obtaining proper consents, sometimes it is better to err on the side of caution and disclose the representation and obtain waivers at the outset of the representation or decline a second representation if it appears that an actual conflict will arise at some point.

7. Disclosures

Bankruptcy Rule 2014 requires disclosure of "any proposed arrangements for compensation, and to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee." The rule is much more comprehensive than the applicable statutes, 11 U.S.C.A. §§ 327, 1103. "Connections" has been broadly construed as well. See e.g. In re Occidental Financial Group, Inc., 40 F.3d 1059 (9th Cir. 1994) (representation of insiders and engagement agreement to analyze financial affairs and file bankruptcy for any one or more of group of clients); *In re Miners Oil Co., Inc*., 502 B.R. 285 (Bankr. W.D. Va. 2013) (engagement agreement clarified firm to represent company, not insider, but principal understood firm would pursue his interests; insufficient disclosure of connections with principal).

It is not for the DIP or its counsel to determine unilaterally whether a connection is relevant; the court is to review all connections and decide whether there are any disqualifying conflicts. What is important are connections that presently exist or recently existed between the

attorney and the parties in interest, and also past connections of business or personal nature that are either related to the bankruptcy proceedings or could reasonably have an effect on the attorney's judgment in the case. *See, e.g. In re eToys, Inc*., 331 B.R. 176 (Bankr. D. Del. 2005); *KLG Gates v. Brown*, 506 B.R. 177 (E.D.N.Y. 2014). Disclosure is an ongoing responsibility. If potential conflicts arise after the initial application and disclosure they should be brought to the court's attention promptly.

Disclosures must be sufficiently detailed to enable the court to understand the magnitude of the connections and potential conflicts, and must be strictly accurate. *See In re American Intern. Refinery, Inc*., 676 F.3d 455 (5th Cir. 2012) (retainer source and attorney's role in prepetition debtor transactions); *In re Dick Cepek, Inc*., 300 Fed. Appx. 497 (9th Cir. 2008) (disclosure of "advance" did not disclose security interest in retainer); *In re Park-Helena Corp*., 63 F.3d 877 (9th Cir. 1995) (failure to provide details of retainer payment; strict compliance with disclosure rules required). See the Ethics Task Force Report at 1-10 discussion of proposed amendments to Bankruptcy Rule 2014.

Consumer

1. Competent and Ethical Processing of Consumer Bankruptcy Cases

Attorneys who provide legal advice and assistance to an individual filing under either Chapter 7 or Chapter 13 of the Bankruptcy Code falls under the definition of "debt relief agency" under 11 U.S.C.A. §101(12)(A). In turn, the actions of a bankruptcy practitioner as debt relief agency are governed by §§ 526(a) and 528. Pursuant to the Code, an attorney hired to assist an individual with a bankruptcy filing are required to meet with the client directly and cannot rely entirely on a paralegal, as paralegals are forbidden to provide legal advice. For a general discussion of the role of attorneys and paralegals in the process of filing and advising the client, see *In re Santiago*, 457 B.R. 172 (D. Puerto Rico 2011). Attorneys who do not meet these requirements can have their fees disgorged, s*ee In re Caise*, 359 B.R. 152 (Bankr. E.D. Ky.

2006) or worse. Two of the more egregious cases of a consumer attorney violating the code and breaching his fiduciary duty is laid out in two separate opinions: *In re Edith Moore, et al.*, 12 - 41111 (CEC) (Bankr. E.D.N.Y. October 3, 2012) and *In re Karl Stromberg*, 10-41603 (Bankr. S.D. Tx. January 10, 2013).

See the Ethics Task Force Report at 49-82 discussion of best practices for limited services representation in consumer bankruptcy cases and competency for debtor's counsel.

2. Ethical Fee Arrangements in Consumer Cases

Upon a filing of a Chapter 7 or Chapter 13 petition, all unsecured pre-petition debt is wiped out. This would include any unpaid attorneys fees owed to the bankruptcy attorney who represents the debtor in the filing. It is for this reason that many practitioners will request that, prior to the filing, the debtor issue the attorney a post-dated check to cover the pre-petition amounts due. While this may once have been considered a creative way around writing off the unpaid, pre-petition expenses, many attorneys have found themselves in hot water over this practice. *See, e.g.*, *In re Davis Jr.*, 2015 WL 1598048 (Bankr. N.D. Ala. Apr. 7, 2015) and *In re Wayne Waldo*, 417 B.R. 854 (Bankr. E.D. Tenn. 2009). A prepetition arrangement to pay a flat fee in installments postpetition has not only been held unenforceable because the obligation is discharged, and collection efforts are a violation of the automatic stay, but also to create a conflict of interest in an individual bankruptcy case. *See Walton v. Clark & Washington, P.C.*, 454 B.R. 537 (Bankr. M.D. Fla. 2011); *In re Martin*, 197 B.R. 120 (Bankr. D. Colo. 1996) (citing cases on dischargeability of prepetition retainer installment agreements). While installment arrangements do not per se create a conflict, upon the petition filing the attorney becomes a self-interested creditor in conflict with the debtor client, who is seeking discharge of prepetition obligations. Contractual remedies for nonpayment of installments and failure to advise the debtor client about caselaw holding such retainers dischargeable illustrates the conflict.

It is not uncommon for a case that is originally filed under Chapter 13 to be converted to a Chapter 7 case. When this occurs, the question arises whether the amounts held in trust to pay

what would have been Chapter 13 creditor are to be considered part of the Chapter 7 estate or whether they should go back to the debtor. This issue was recently addressed by the United States Supreme Court in *Harris v. Viegelahn*, 2015 U.S. LEXIS 3203 (S.Ct. 2015) where the Court held that the funds should go back to the debtor.

Also unique to the consumer side is the potential consequences for "unbundling" services on the premise of saving the debtor costs. For example, an attorney may agree to charge a flat rate to a consumer for a Chapter 7 proceeding but extra for any adversary proceedings that arise or agree to file petitions but not to attend a 341 meeting. *See, e.g.*, *Offer Unbundled Legal Services to Compete in Today's Legal Market* by Stephanie Kimbro, www.Lawyerist.com, September 4, 2014. However, in *DeLuca v. Seare (In re: Seare)*, BAP No. NV-13-1196, August 25, 2014, the Court held that, while when "done correctly," an attorney can ethically unbundle services in jurisdictions which allow it, counsel in this case did not do so properly. Some factors that Judge Jury listed as requirements for unbundling include educating the client on potential additional matters for which they might be charged; becoming fully knowledgeable about the debtor's debts prior to agreeing to unbundle; and customizing one's practice to the specific needs of that particular debtor.

3. Recommending Chapter 13 or Chapter 7 – the Impact of Fee Alternatives

There are various reasons why a creditor would choose to file under Chapter 7 rather than Chapter 13, or vice versa. One of these differences is that a Chapter 7 debtor may pay his or her counsel in installments, which is not allowed in a case filed under Chapter 13. However, it is considered a bad faith filing if the sole reason a debtor files under Chapter 13 rather than Chapter 7 is so that the debtor may pay the counsel's fees in installments. *See*, *In re Lerin Brown*, 13-10260 (11th Cir. 2014).