ABI 2006

Mid-Atlantic Bankruptcy Workshop

August 3-5, 2006
Hyatt Regency Chesapeake Bay, Cambridge, Maryland

"If You Can't Do the Time . . ." -- Bankruptcy Crimes and Fraud

Panelists:

Kelly Beaudin Stapleton
United States Trustee for Region 3
833 Chestnut Street, Suite 500
Philadelphia, PA 19107
USTP.Region03@usdoj.gov

Richard E. Byrne
Chief, Criminal Enforcement Unit
United States Department of Justice
Executive Office for U.S. Trustees
20 Massachusetts Ave., N.W., Suite 8217
Washington, D.C. 20530
Richard.Byrne@usdoj.gov

Stephen A. Donato, Esquire
Bond, Schoeneck & King PLLC
One Lincoln Center
Syracuse, NY 13202
sdonato@bsk.com

Ronald S. Gellert, Esquire
Eckert Seamans Cherin & Mellott, LLC
300 Delaware Avenue
Suite 1360
Wilmington, DE 19801
rgellert@eckertseamans.com

Richard M. Kremen, Esquire
DLA Piper Rudnick Gray Cary US LLP
6225 Smith Avenue
Baltimore, MD 21209-3600
richard.kremen@dlapiper.com

1207760.2 7/27/2006

ABI CAMBRIDGE
Bankruptcy Crimes and Fraud

I. Overview of USTP/DOJ Criminal Enforcement Efforts[1]

A. Statutory Obligations to Refer -- 28 U.S.C. ' 586 & 18 U.S.C. ' 3057

The United States Trustee Program (AUSTP@) has a statutory obligation to refer matters to the appropriate United States attorney that relate to the occurrence of any action which may constitute a crime, and at the request of the United States attorney, to assist the United States attorney in carrying out prosecutions based on such action.[2] If bankruptcy judges or private trustees have reasonable grounds to believe that a violation of law relating to bankruptcy has occurred or that an investigation should be initiated, then they shall report the underlying facts and circumstances to the appropriate United States attorney, including the names of all the witnesses and the offenses suspected.[3] Upon receipt of this information, the United States attorney shall inquire into the facts and present the matter to the grand jury if it appears probable that any such offense has been committed, unless upon inquiry and examination the United States attorney decides that the ends of public justice do not require investigation or prosecution, in which case he shall report the facts to the Attorney General for his direction.[4]

B. USTP=s Criminal Enforcement Unit

To assist with the USTP's mission to protect the integrity of the bankruptcy system, in 2003 the Executive Office for United States Trustees ("EOUST") established a Criminal Enforcement Unit ("CREU"), which consists of experienced former federal prosecutors. CREU's mission includes working with Program staff to identify and refer possible criminal conduct and to assist federal law enforcement agencies and United States attorney offices ("USAOs") with bankruptcy-related investigations and prosecutions, and to conduct training for Program personnel, private trustees, prosecutors, and law enforcement agents. Last year alone, members of CREU trained approximately 1,500 people in various training programs around the country.

[1] Written by Richard E. Byrne, Chief, Criminal Enforcement Unit, United States Department of Justice, Executive Office for United States Trustees. Additional thanks to Joseph J. McMahon, Jr., Trial Attorney, Office of the United States Trustee, Wilmington, Delaware for his edits of the entire document.

Please note that the views expressed in this document are not the views of the United States Trustee for Region 3, the Executive Office for United States Trustees, the United States Trustee Program, and/or the United States Department of Justice.

[2] *See* 28 U.S.C. ' 586(a)(3)(F) (2005).
[3] *See* 18 U.S.C. ' 3057(a) (2005).
[4] *See* 18 U.S.C. ' 3057(b).

C. Bankruptcy Abuse Prevention and Consumer Protection Act (the "BAPCPA") Designation Requirements

Every USAO and every Federal Bureau of Investigation field office must designate one prosecutor and one special agent, respectively, to investigate and prosecute violations of 18 U.S.C. '' 152 and 157, relating to materially false statements made in bankruptcy schedules and abusive reaffirmations of debt.[5] Each United States attorney who is designated shall, in addition to any other responsibilities, have primary responsibility for carrying out the duties of a United States attorney under section 3057.[6] In addition, the bankruptcy court is required to establish procedures for referring any case that may contain a materially fraudulent statement in a bankruptcy schedule to the appropriate United States attorney or special agent.[7]

D. The BAPCPA=s New Debtor Audits

The United States trustee for each district is authorized to contract with auditors to perform audits in cases designated by the United States trustee, in accordance with the procedures established under section 603(a) of the BAPCPA.[8] The report of each audit is to be filed with the court and transmitted to the United States trustee. Each report shall clearly and conspicuously specify any material misstatement of income or expenditures or of assets identified by the person performing the audit. Where a material misstatement of income, expenditures, or assets is reported, the clerk of the district court shall give notice of the misstatement to the creditors in the case.[9] If a material misstatement is reported, the United States trustee shall report it to the designated United States attorney and take appropriate action, including but not limited to commencing an adversary proceeding to revoke the debtor's discharge.[10]

E. Bankruptcy Fraud Working Groups

To better facilitate coordination between the USTP, USAOs, and federal law enforcement agencies relating to bankruptcy investigations and prosecutions, the Department of Justice utilizes local bankruptcy fraud working groups. A representative of the USTP, USAO, and several federal law enforcement agencies typically make up a working group, which meets periodically to discuss ongoing bankruptcy fraud investigations and pending criminal referrals.

---

[5] *See* 18 U.S.C. ' 158(a).
[6] *See* 18 U.S.C. ' 158(c).
[7] *See* 18 U.S.C. ' 158(d).
[8] *See* 28 U.S.C. ' 586 (f)(1).
[9] *See* 28 U.S.C. ' 586 (f)(2)(a).
[10] *See* 28 U.S.C. ' 586 (f)(2)(b).

Additionally, there is a National Bankruptcy Fraud Working Group ("NBFWG"), which consists of a representative from the USTP, USAOs, the Department's Criminal Division, FBI, Internal Revenue Service-Criminal Investigation, Postal Inspection Service, United States Secret Service, Housing and Urban Development Office of Inspector General, Social Security Administration Office of Inspector General, Federal Trade Commission, and Executive Office for United States Attorneys, as well as other agencies. The NBFWG, which meets approximately once a year, helps coordinate a national response to bankruptcy fraud issues.

F. Summary of National Criminal Enforcement Efforts

In October, 2004, the USTP announced "Operation SILVER SCREEN," which highlighted the indictment of twenty-one individuals in seventeen separate prosecutions and demonstrated the breadth of enforcement actions taken by the Department of Justice in combating bankruptcy fraud and protecting the integrity of the bankruptcy system. The press release issued by the Program relating to Operation SILVER SCREEN can be found at http://www.usdoj.gov/ust/eo/public_affairs/press/docs/silver_screen_final_10-28-04.htm. The cases collectively involved the concealment of more than $7 million in assets, illegal conduct by professionals, use of false Social Security numbers and false identities, submission of forged documents, false statements, and various fraudulent acts. As of this writing, the coordinated effort, dubbed "Operation SILVER SCREEN" in recognition of the USTP's enhanced screening of bankruptcy cases to identify fraud and abuse, has resulted in twelve defendants being convicted of, or pleading guilty to, bankruptcy-related crimes.

II. The United States Trustee's Mandatory Obligation to Move for Appointment of a Chapter 11 Trustee – 11 U.S.C. § 1104(e)[11]

A. Background and History of the Subsection

During the bankruptcy cases of Enron and WorldCom, examiners were appointed to investigate the much-publicized scandals affecting their businesses. The fraud-laden schemes engaged in by corporate officers and directors that were uncovered in these investigations not only attracted headlines, but also the attention of Congress. While the Bankruptcy Code has long permitted the appointment of a trustee or examiner in chapter 11 cases, the U.S. Trustee was not required to move for the appointment of a trustee or examiner in such cases. Seizing the opportunity, Congress amended the Bankruptcy Code in an effort to provide a more assertive means by which to investigate a debtor's affairs where actual fraudulent or dishonest behavior is

11 Written by Stephen A. Donato, Esquire, Bond, Schoeneck & King PLLC. Syracuse, New York. The author refers the reader to the excellent article entitled, "Zero Tolerance for Commercial Bankruptcy Fraud: Bankruptcy Metrics Dictate Forewarned is Forearmed" published in the December/January 2006 ABI Journal and presented at the December 2005 ABI Winter Leadership Conference, Educational Session of the Commercial Fraud Task Force Committee by the co-authors, Daniel A. Austin, Esq., Pennsylvania, Robert J. Musso, Esq., and Ch. 7 panel trustee Eastern District of New York, Rosenberg, Musso & Weiner, New York, Jack Seward, Jack Seward & Associates, LLC New York, and Bruce Weiner, Esq., Rosenberg, Musso & Weiner, New York for an in depth and thorough discussion of bankruptcy fraud topics.

suspected. The amendment, part of the BAPCPA, is found at 11 U.S.C. 1104(e).[12] This subsection provides that:

> The United States Trustee shall move for the appointment of a trustee under subsection (a) if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.

Since 11 U.S.C. § 1104(e) is relatively new, there are currently no reported cases concerning this subsection.

B. Zero Tolerance for Fraud and Abuse

Section 1104(e), which mandates that the United States trustee file a motion for the appointment of a chapter 11 trustee in certain circumstances, ensures that an increased number of bankruptcy debtors will be scrutinized by appointed trustees. This powerful mandate adds sharper teeth to the Bankruptcy Code and augments the likelihood that those engaged in actual fraudulent or dishonest conduct will be uncovered, removed and possibly subjected to criminal sanctions. Now that the United States trustee is compelled to move for the appointment of a trustee, it is possible that the United States trustee will act at an early stage of the proceedings when the facts and circumstances concerning the alleged fraudulent conduct have not been fully and thoroughly investigated. So long as the United States trustee has reasonable grounds to suspect criminal conduct, she will move quickly to appoint a trustee to intercede and investigate a debtor suspected of wrongdoing.

C. Opportunity for Greater Creditor Participation

Since section 1104(e) mandates that the United States trustee move for the appointment of a chapter 11 trustee where the trustee has reasonable grounds to suspect actual fraudulent conduct, dishonest conduct, or criminal activity, creditors now have a greater opportunity to participate in the proceedings of a chapter 11 case. While this new section was enacted in response to alleged fraudulent conduct in larger chapter 11 cases such as Enron and WordCom, it is apparent that this section will also benefit creditors in smaller cases by providing them the opportunity to submit information and evidence to the United States trustee. Unlike before, if the information provided by the creditor creates "reasonable grounds" of suspicion, the United States trustee is now obligated to take action and move for the appointment of a trustee. In order to impact the proceedings in this way, the creditor should, immediately upon the debtor's filing,

---

12 The BAPCPA was signed into law on April 20, 2005. Certain sections of the BAPCPA (including 11 U.S.C. § 1104(e)) became effective immediately. Such sections apply to all cases filed on or after that date.

collect relevant information of actual fraudulent or criminal behavior on the part of the debtor or its constituent members, officers or directors. This information should be passed on to the creditor's attorney for review and ultimately forwarded to the Office of the United States Trustee. The Office of the United States Trustee will determine whether reasonable grounds exist to appoint a chapter 11 trustee.

The appointed chapter 11 trustee will then review the information provided by the creditor, which information will form the basis for a more thorough and expedited investigation of the debtor. Since this information will allow the appointed trustee to become more knowledgeable about the debtor in a shorter period of time, the trustee can rapidly move, for example, to protect the computing systems of the debtor, the primary source of financial and other information about the debtor. If the debtor did engage in accounting improprieties or bankruptcy fraud, the information contained on the computer devices would more than likely disclose such conduct.

It is readily apparent, therefore, that creditors will now play a much more prominent role in chapter 11 cases by assembling information and forwarding it to the United States trustee for consideration in the appointment of a chapter 11 trustee.

D. What Does "Information About the Debtor" Mean?

Unsupported accusations about the debtor will not compel the United States trustee to move for the appointment of a chapter 11 trustee. Instead, if a creditor seeks to successfully compel the United States trustee to move for the appointment of a chapter 11 trustee, the information provided about the debtor must be sufficient to create reasonable grounds to suspect that the governing agents of the debtor engaged in some type of villainous behavior in managing the commercial debtor or in its public financial reporting. To this end, the information presented should be in the form of hard evidence. In other words, the creditor seeking to impact a chapter 11 case by causing the appointment of a chapter 11 trustee should submit hard copies of documents, including hard copy and electronic documents substantiating the claimed dishonest or actual fraudulent conduct at issue.

E. What are "Reasonable Grounds to Suspect?"

The phrase "reasonable grounds to suspect" is one of the many interpretation issues left unresolved by section 1104(e).[13] Since this phrase is not defined in the statute itself, an examination of the jurisprudential usage of the phrase is in order. The standard of "reasonable grounds to suspect" appears to have been most commonly utilized in Fourth Amendment cases involving the stopping, detaining and questioning of those suspected of criminal activity. The "reasonable grounds to suspect" evidentiary standard, in this context, has been described as something less than probable cause. More specifically, the United States Supreme Court has

13 As an aside, a possible explanation for the numerous unanswered issues presented by this section is that it was added to the BAPCPA during Senate Judiciary Committee mark-up only two months prior to being signed into law.

defined the phrase to mean that an officer who conducts an investigatory stop must articulate "a particularized and objective basis for suspecting the particular person stopped of criminal activity."[14] This definition requires that the officer identify a specific objective basis to confirm any hunch or gut-feeling before detaining a suspect. A stop that does not meet the "reasonable grounds to suspect" standard would be unreasonable under Fourth Amendment law.

Based on the foregoing, it appears that the interpretation of "reasonable grounds to suspect" under section 1104(e) would be similar. In other words, this standard would appear to require the United States trustee to have more than a hunch that wrongdoing has occurred. Instead, the United States trustee's suspicion of actual fraudulent, dishonest or criminal conduct must be grounded on objective evidence. This underscores the importance of a creditor seeking to affect the proceedings by providing hard evidence to the United States trustee. At the same time, however, "reasonable grounds to suspect" is not an onerous standard, and is likely to be met in cases where limited evidence exists.

F. The United States Trustee's Role

Section 1104(e), while mandating that the United States trustee move for the appointment of a trustee in certain circumstances, does not speak to the role or level of involvement the United States trustee is to play in a chapter 11 case. Should the United States trustee be passive and patiently await the presentation of evidence and materials before investigating a chapter 11 debtor, or should the United States trustee actively inquire into the dealings of each debtor? Not only does section 1104(e) fail to address the role the United States trustee is to play, but 28 U.S.C. § 586, which sets forth the duties of United States trustees, was not amended to account for the newly-added section 1104(e).

In addition, section 1104(e) does not provide a remedy in the event that the United States trustee fails to move for the appointment of a chapter 11 trustee. A private party may well be able to move to compel the chapter 11 trustee to act pursuant to section 1104(e). However, if that private party is an interested party, it may be simpler to move directly for the appointment of a trustee or examiner by motion to the court under 11 U.S.C. § 1104(a).[15]

---

14 *Illinois v. Wardlow*, 528 U.S. 119, 128 (2000); *United States v. Cortez*, 449 U.S. 411, 417-418 (1981).

15 11 U.S.C. § 1104(a) provides:

> At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee
>
> (1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor;
>
> (2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or
>
> (3) if grounds exist to convert or dismiss the case under section 1112, but the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate.

G. Conclusion

Section 1104(e) was introduced in response to large-scale fraud and criminal conduct. However, this section is framed in a manner that permits creditors to benefit in much smaller and lower-profile cases. While the impact of this section on creditors and the United States trustee remains uncertain, it is clear that section 1104(e) has introduced many interpretive challenges and uncertainties to chapter 11 cases. Although the courts have not yet been summoned to provide guidance with regard to this section, courts will likely have opportunities to interpret section 1104(e) and the United States trustee's duties thereunder in the near future.

III. Potential Creditor Pitfalls -- From the Obvious to the Bizarre[16]

It is particularly important to note that bankruptcy crimes are not limited to debtor/principal constituents only. There are a number of acts that creditors may employ to attempt to obtain a greater recovery than would ordinarily be received in a particular bankruptcy case. While it is clear that creditors are entitled to take all necessary steps, within the scope of the law, to protect their pecuniary interests, oftentimes creditors take additional steps that run afoul of the law. This section is dedicated to illuminating those acts that may not be taken in advancing creditors' rights.

A. Concealment of Assets, False Oaths and Claims; Bribery – 18 U.S.C. § 152

Title 18 of the United States Code governs "Crimes and Criminal Procedure." Specifically, those crimes relating to bankruptcy matters (Title 11) are enumerated in 18 U.S.C. § 152. The crimes enumerated in 18 U.S.C. § 152 are applicable to, and indeed have been applied against, creditors performing the acts identified in this section. The criminal acts enumerated in 18 U.S.C. § 152 are:

> §152. Concealment of assets, false oaths and claims, bribery
>
> A person who—
>
> (1) knowingly and fraudulently conceals from a custodian, trustee, marshal, or other officer of the court charged with the control or custody of property, or, in connection with a case under title 11, from creditors or the United States Trustee, any property belonging to the estate of a debtor;
>
> (2) knowingly and fraudulently makes a false oath or account in or in relation to any case under title 11;

16 Written by Ronald S. Gellert, Esquire, Member, Eckert Seamans Cherin & Mellott, LLC, Wilmington, Delaware. Special thanks to Diane Sirull, Esquire and Erin Pearson for their research and writing assistance.

(3) knowingly and fraudulently makes a false declaration, certificate, verification, or statement under penalty of perjury as permitted under section 1746 of title 28, in or in relation to any case under title 11;

(4) knowingly and fraudulently presents any false claim for proof against the estate of a debtor, or uses any such claim in any case under title 11, in a personal capacity or as or through an agent, proxy, or attorney;

(5) knowingly and fraudulently receives any material amount of property from a debtor after the filing of a case under title 11, with intent to defeat the provisions of title 11;

(6) knowingly and fraudulently gives, offers, receives, or attempts to obtain any money or property, remuneration, compensation, reward, advantage, or promise thereof for acting or forbearing to act in any case under title 11;

(7) in a personal capacity or as an agent or officer of any person or corporation, in contemplation of a case under title 11 by or against the person or any other person or corporation, or with intent to defeat the provisions of title 11, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation;

(8) after the filing of a case under title 11 or in contemplation thereof, knowingly and fraudulently conceals, destroys, mutilates, falsifies, or makes a false entry in any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor; or

(9) after the filing of a case under title 11, knowingly and fraudulently withholds from a custodian, trustee, marshal, or other officer of the court or a United States Trustee entitled to its possession, any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor,

shall be fined under this title, imprisoned not more than 5 years, or both.[17]

17 18 U.S.C. § 152 (2005).

Clearly, several of these provisions, such as subsections four (knowing presentment of false claim against estate) and five (knowing and fraudulent post-petition receipt of estate property to avoid provisions of Title 11) are aimed directly at creditors and their acts during a bankruptcy proceeding. Other subsections are generally applicable to parties involved in a bankruptcy proceeding, including creditors.

1. Filing False Claims – 18 U.S.C. § 152(4)

This subsection is straightforward. When a creditor knowingly and fraudulent submits a false proof of claim, the creditor is going to be subject to criminal liability. In fact, the penalties for such acts are relatively serious, including a fine (previously capped at $500,000) and/or imprisonment for up to five years.[18] Such penalties are purposefully severe so as to apply a distinct deterrent: "[t]hese criminal sanctions . . . are the proper remedies to be applied to creditors . . . who routinely file unlawful claims . . . . [C]reditors . . . filing overstated claims in the expectation that the claims will not be scrutinized or that their amendment when they are caught will remedy any problems that are discovered do so at their peril."[19]

2. Receipt of Estate Assets – 18 U.S.C. § 152(5)

18 U.S.C. § 152(5) describes the crime of receiving any material amount of property post-petition from the debtor with the intent to circumvent title 11. While "material" is undefined, it is clear that courts have interpreted this subsection of 18 U.S.C. § 152 broadly.[20] Further, even where the property was not technically held by a debtor at the time of transfer, to the extent that the debtor retained a property interest that could be deemed within the broad scope of 11 U.S.C. § 541, the transferee may be found criminally liable. [21] Moreover, and albeit not surprising, a court may find a creditor to be criminally liable for participating in a clandestine arrangement whereby the creditor received payment from the debtor in return for accepting the plan and influencing similarly-situated creditors to accept the plan.[22]

3. Bribery – 18 U.S.C. § 152(6)

18 *See In re Burkett*, 329 B.R. 820, 830 n.7 (Bankr. S.D. Ohio 2005) (recognizing stiff deterrent to filing false claims).

19 *In re Shank*, 315 B.R. 799, 815−16 (Bankr. N.D. Ga. 2004).

20 *See United States v. Wernikove*, 206 F. Supp. 407, 409 (E.D. Pa. 1962) (interpreting statute broadly so as to include all forms of property received with intent to defeat the provisions of Title 11).

21 *See United States v. Cardall*, 885 F.2d 656, 676−77 (10th Cir. 1989) (upholding lower court's conviction of defendant under 18 U.S.C. § 152(5) for receiving a transfer from non-debtor account where evidence demonstrated that transferee was particularly knowledgeable of inter-company transactions and ownership rights of the funds received).

22 *See Lurie v. United States*, 20 F.2d 589, 590 (6th Cir. 1927) (noting that the creditors' plan would not have worked "without intentional and express deception of the judge of the bankruptcy court").

In addition, a creditor who receives a transfer from the debtor in return for a favorable vote on a plan may also be criminally liable for bribery under 18 U.S.C. § 152(6).[23] An offer to settle a suit pre-petition such that the creditor's settlement would not be listed on the debtor's bankruptcy schedules and/or other disclosures, with the intent to avoid a discharge of the settlement, may be deemed bribery and/or extortion that would give rise to criminal liability under 18 U.S.C. § 152(6).[24]

4. <u>"Take Your Pick" – Conduct Which Violates Multiple Subsections Under 18 U.S.C. § 152</u>

The United States Court of Appeals for the Seventh Circuit case titled *United States v. Knox*[25] details everything that a creditor should not do. *Knox* involved a creditor who had previously been awarded a default judgment in a civil matter prior to the debtor's bankruptcy. The creditor took extraordinary steps to attempt to recover on the judgment. Upon discovering that the debtor filed its chapter 11 petition prior to the default judgment becoming final, the creditor hired two men in the "collection" business to recover the debt. The two collection agents employed verbal threats and physical intimidation in their collection efforts; the agents "staked out" the home of the debtor's president and made multiple, unannounced visits to the debtor's offices. Cooperating with Federal Bureau of Investigation agents, the debtor's president advised the collection agents on multiple occasions that the company was in bankruptcy, that the claim would be processed in the course of the case, and that any payment outside of the case would be a criminal act for both debtor and creditor. Undeterred, the collection agents pressed for payment. Eventually, the FBI (with assistance from the debtor's president) carried out a "sting" whereby the collection agents were to have received their money, at which point the collection agents (and later the creditor) were arrested and subsequently convicted under, *inter alia*, the bankruptcy fraud provisions of 18 U.S.C. § 152.

5. <u>Other Crimes Under 18 U.S.C. § 152</u>

a. Bid-Rigging

In *United States v. Zehrbach*, the potential purchaser was convicted of bankruptcy fraud and conspiracy to commit bankruptcy fraud for paying other potential bidders to withdraw their bids for debtors' assets, thereby enabling purchaser to submit the sole bid at a lower value.[26]

---

23 *See id.* at 590 ("Private and special payments to a creditor to induce him to vote for a composition are not in terms here forbidden, but it cannot be the intent that the minority of creditors may be coerced by a majority secured by bribery.").

24 *See Christenson v. Aiken (In re Aiken)*, 80 B.R. 971, 973 (Bankr. E.D .Mo. 1988) (noting the possibility of criminal liability; court found that debtor whose actions "amount[ed] to sketchy offers to settle the debt" was not criminally liable for bribery or extortion).

25 68 F.3d 990 (7th Cir. 1995).

26 *See United States v. Zehrbach*, 47 F.3d 1252, 1267 (3d Cir. 1995) (affirming the conviction).

b. Pre-Petition Removal of Assets

In *United States v. Sabbeth*, the debtor's principal, who questionably determined that he was owed funds from a debtor, removed assets of the debtor for his personal use prior to the company's filing chapter 11.[27] Not only did this give rise to fraudulent transfer and preference liability, but the principal was convicted of bankruptcy fraud under 18 U.S.C. § 152 as well as money laundering under 18 U.S.C. § 1956.[28]

B. Involuntary Cases – 11 U.S.C. § 303

Prior to the 2005 BAPCPA amendments, the issue of whether the filing of an involuntary case for an improper purpose gave rise to criminal liability under 18 U.S.C. § 151 *et seq.* was an open question. For instance, it had been previously suggested that "a creditor [who] initiates an involuntary petition against a debtor for the sole purpose of pressuring a debtor into paying a disputed claim" may face criminal liability.[29] On the other hand, some courts specifically noted that the sanction provisions of § 303(i) are the sole remedy for an improper involuntary filing and that there is no explicit statutory authority to impose penalties under 18 U.S.C. § 151 *et eq*.[30]

The BAPCPA amendments (18 U.S.C § 157) helped clarify the question of whether criminal liability may be imputed to a creditor who improperly brings an involuntary case.[31] This section provides:

> 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 –
>
> (1) files a petition under title 11, <u>including a fraudulent involuntary bankruptcy petition under section 303 of such title</u>,
>
> … shall be fined under this title, imprisoned not more than 5 years, or both.[32]

Thus, while the statute remains unclear as to what amounts to a fraudulent involuntary bankruptcy petition, a creditor must be cognizant not only of the court's authority to issue civil sanctions under § 303(i), but also of the criminal liability which may follow. As such, the threat

---

27 *See United States v. Sabbeth,* 125 F. Supp. 2d 33, 37−39 (E.D.N.Y. 2000) (concluding that criminal act was complete upon the transfer from the corporation to the principal and rejecting defendant's assertion that the transferred monies were his property until the trustee recovered them).
28 *See id.* (listing counts of conviction).
29 ROSEMARY WILLIAMS, 1 BANKRUPTCY PRACTICE HANDBOOK § 6:49 (2d ed.),.
30 *In re Schloss*, 262 B.R. 111, 118 (Bankr. M.D. Fla. 2000) (awarding sanctions under §303 but rejecting imposition of criminal sanctions).
31 *See* 18 U.S.C. § 157(1) (setting forth sanctions for bankruptcy fraud).
32 18 U.S.C. § 157 (emphasis added).

of criminal liability should remain a distinct factor for consideration when evaluating whether to file an involuntary case under § 303.

C. Abusive Reaffirmations – 18 U.S.C. § 158

11 U.S.C. § 158 was enacted as part of the BAPCPA amendments and specifically grants the Attorney General the responsibility of designating those individuals who will have "primary responsibility in carrying out enforcement activities in addressing violations of section 152 or 157 relating to abusive reaffirmations of debt."[33] This section specifies that the individuals with such responsibility shall be (1) "the United States attorney for each judicial district of the United States" and (2) "an agent of the Federal Bureau of Investigation for each field office of the Federal Bureau of Investigation."[34]

Courts view reaffirmation agreements as "the creditor's playthings."[35] Therefore, creditors must be cognizant of this fact and take the necessary steps to ensure that any reaffirmation agreement they propose to a debtor complies with all requirements, especially in light of 18 U.S.C. § 158. One requirement that creditors commonly do not comply with is the requirement that the reaffirmation agreement be filed with the court.[36]

Prior to the enactment of section 158, courts were split over whether 11 U.S.C. § 524 contains a private right of action for a violation of that section. In those courts that did not recognize such a private right of action, refusal to enforce the reaffirmation agreement was the only remedy available to "punish" a creditor who did not comply with applicable requirements.

In *Bessette v. Avco Financial Services., Inc.*, the United States Court of Appeals for the First Circuit was faced with a reaffirmation agreement that did not comply with the necessary conditions of 11 U.S.C. § 524.[37] Specifically, the creditor did not file the reaffirmation agreement with the court, and the reaffirmation agreement did not "advise the debtor[38] that the agreement may be rescinded within sixty days of the date of the filing with the court."[39] The First Circuit held that 11 U.S.C. § 105 "provides a bankruptcy court with statutory contempt powers" and that "[t]hose contempt powers inherently include the ability to sanction a party."[40] As such, the Court held that courts may use their contempt powers to award monetary relief to a

---

33 18 U.S.C. § 158.
34 *Id.*
35 *See Sears, Roebuck & Co. v. Spivey*, 265 B.R. 357, 366 (E.D.N.Y. 2001) (stating that because reaffirmation agreements require creditor consent, they are regarded as "creditor's playthings").
36 *See* 11 U.S.C. § 524(c)(3) (2001) (stating that reaffirmation agreements need to be filed with the court to be enforceable).
37 *See Bessette v. Avco Fin. Servs., Inc*., 230 F.3d 439, 444 (1st Cir. 2000) (stating that "[t]here is no dispute that the reaffirmation agreement involved in this case falls short of the § 524 criteria").
38 While 11 U.S.C. § 524(c) previously required that a reaffirmation agreement contain language advising the debtor that it could be rescinded at any time prior to discharge or within sixty days after the agreement was filed with the court, under BAPCPA, this is no longer a requirement.
39 *Id.*
40 *Id.* at 444−48.

debtor.[41] However, in *Pertuso v. Ford Motor Credit Co.*[42], the United States Court of Appeals for the Sixth Circuit addressed a situation similar to the one described in *Bessette* (i.e., a reaffirmation agreement that was not filed with the court). The Sixth Circuit held that 11 U.S.C. § 105 does not grant the court the power to sanction a party in that context.[43]

Despite the split in authority over whether a creditor that violates 11 U.S.C. § 524 can be civilly sanctioned, 18 U.S.C. § 158 makes it clear that a creditor who abuses reaffirmation of debt will face criminal prosecution. Therefore, creditors must be careful not to violate sections 152 and 157.

D. Actions to Force Settlement – 11 U.S.C. § 727

In addition to the foregoing concerns, creditors who wish to extract some benefit or leverage from bringing an action for denial of discharge pursuant to 11 U.S.C. § 727 need to be particularly careful when contemplating a settlement of that action with the debtor. In essence, the creditor who brings such an action is viewed as a trustee with an obligation to ensure that the bad acts of a debtor prohibit the discharge of all debts (as opposed to an action arising under section 523 where the non-dischargeability results in the denial of discharge as to one specific claim).

Thus, where a creditor/plaintiff in a section 727 action reaches a settlement which, in return for dismissing the action, benefits only that creditor (as opposed to the entire creditor body), such action may be contrary to public policy and possibly could be referred for further criminal investigation under 18 U.S.C. § 152(5, 6).[44]

IV. Ethical Considerations for Attorneys[45]

Today's bankruptcy attorneys face a multitude of ethical responsibilities when representing their clients. Indeed, bankruptcy attorneys representing an entity in the zone of

---

41 *See id.* at 445 (finding that courts have the power to award monetary relief).
42 233 F.3d 417 (6th Cir. 2000).
43 *See id.* at 423 (rejecting the argument that "§ 105 could . . . be invoked to remedy breaches of § 363 . . .").
44 *See* 18 U.S.C. § 152 (5, 6) (creating sanctions for receipt of value outside of Title 11 provisions or for advantage for forbearance); *Burns v. Hassan (In re Hassan)*, 2005 Bankr. Lexis 2168, *2 (Bankr. N.D. Ga.) ("Discharge is not a commodity subject to negotiation. Such an exchange may be grounds for a criminal action."); *Royal Bank of Pa. v. Grosse (In re Grosse)*, 1997 Bankr. Lexis 2351*14−16 (Bankr. E.D. Pa.) (citing cases finding that negotiated discharges are against public policy); *Moister v. Vickers (In re Vickers)*, 176 B.R. 287, 290 n. 10 (Bankr. N.D. Ga. 1994) (stating that "[d]ischarges are not property of the estate and are not for sale"); *In re Moore*, 50 B.R. 661, 664 (Bankr. E.D. Tenn. 1985) (noting that, because of the influence of public policy upon discharges, discharges cannot be part of contract negotiations); *see also In re Levy*, 127 F.2d 62, 63 (3d Cir. 1942) (deeming illegal cash offer from third party to creditors committee to drop turnover proceeding in exchange for committee's agreement not to contest debtor's discharge).

45 Prepared by Richard M. Kremen, Esq., DLA Piper Rudnick Gray Cary US LLP, 6225 Smith Avenue, Baltimore, Maryland 21209-3600, Tel: 410.580.3000, Fax: 410.580.3001, Email: richard.kremen@dlapiper.com.

insolvency, the debtor-in-possession, a trustee, a creditor, or an official creditors' committee owe extensive ethical and fiduciary duties to their clients, as defined by the Bankruptcy Code, applicable bankruptcy case law, the American Bar Association's Model Rules of Professional Conduct, and applicable state law. For example, one of the greatest professional nightmares a chapter 11 debtor's attorney can face is discovering, during a bankruptcy case, that the people running the debtor are crooks. Such a discovery should immediately cause the attorney to seriously consider whether he should withdraw from representing the debtor (assuming that the individuals acting as debtors-in-possession do not take steps to rectify their improper actions, this action is probably inevitable). All too often, even seasoned bankruptcy attorneys fail to recognize these ethical pitfalls when they surface during the course of the representation. The failure of counsel to behave prudently can lead to dire consequences, including ethics complaints and disbarment proceedings. To be sure, a number of high-visibility, adverse decisions resulting in disqualification of counsel, denial of compensation, and disgorgement of fees have made bankruptcy attorneys more cautious than ever in the way they approach new engagements. Consequently, bankruptcy attorneys must educate themselves about the scope of their ethical duties and the types of issues that are likely to face during the engagement.

ETHICAL OBLIGATIONS OF ATTORNEYS

A. Ethical Duties Under The Model Rules

1. Duty of Competent Representation

MRPC 1.1 provides that a lawyer shall provide competent representation to a client. This requires legal knowledge, skill, thoroughness, and preparation reasonably necessary to handle the representation. In the bankruptcy context, a lawyer who is unfamiliar with the Bankruptcy Code would likely be breaching his duty of representation if he was to undertake the representation, as bankruptcy counsel, of a corporation who is preparing to, or has, filed for bankruptcy protection.

2. Duty of Diligence

MRPC 1.3 requires that a "lawyer act with reasonable diligence and promptness in representing a client."

3. Duty of Communication

MRPC 1.4 requires a lawyer to maintain contact with the client. The lawyer must obtain the client's consent when necessary, discuss the objectives of the representation and how they are to be accomplished, and inform the client about the status of the matter. The attorney must keep the client *reasonably* informed of the status of the case. Also, an attorney must return telephone calls or emails from his client and respond to requests for information from the client.

4. Duty to Maintain Attorney-Client Privilege / Confidentiality

MRPC 1.6 requires that a lawyer not disclose any information relating to the representation of a client without the client's consent, implied authorization in order to carry out the representation or the disclosure is permitted to, *inter alia*, "prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services; . . . prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services; . . . to secure legal advice about the lawyer's compliance with these Rules; . . . 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 . . . to comply with other law or a court order." *See generally Hansen, Jones & Leta, P.C. v. Segal*, 220 B.R. at 454 (counsel for debtors in possession owe a duty to maintain client confidentiality).

5. Duty to Abstain from Conflicts of Interest (MRPC 1.7, 1.8, 1.9 and 1.10)

B. Duties Arising Under the Bankruptcy Code

1. Debtor's Retention of Professionals Under 11 U.S.C. § 327(a): Duties of "Disinterestedness" and "No Adverse Interest."

To establish eligibility for retention under section 327, the professional: (1) must be "disinterested"; and (2) must not hold or represent any interest adverse to the estate.

Under amended section 101(14), the term "disinterested person" means a person that (a) is not a creditor, an equity security holder, or an insider; (b) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and (c) 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, in connection with, or interest in, the debtor, or for any other reason. (Note that the BAPCPA has deleted all prior references to investment bankers for purposes of the "disinterested" standard). An attorney for a debtor-in-possession or creditors' committee must be disinterested and not hold any interest adverse to the bankruptcy estate in order to ensure that the lawyers provide undivided loyalty and untainted advice and assistance in furtherance of their fiduciaries responsibilities. *See In re EZ Links Golf, LLC,* 317 B.R. 858, 862 (Bankr.D.Colo. 2004) (debtor's counsel); *In re Greystone Holdings, LLC*, 305 B.R. 456, 460 (Bank.N.D.Ohio 2003) (citing *Kravit, Gass & Weber, S.C. v. Michel (In re Crivello)*, 134 F.3d 831, 836 (7^{th} Cir. 1998) (counsel for creditors' committee).

"Adverse interest" has been defined as either: (i) the possession or assertion of any economic interest that would tend to lessen the value of the bankruptcy estate or create an actual or potential dispute with the estate as a rival claimant; or (ii) a predisposition of bias against the estate. *See In re Granite Partners, L.P.*, 219 B.R. 22, 23 (Bankr. S.D.N.Y. 1998).

Under Federal Rule of Bankruptcy Procedure 2014(a), the employment application and the accompanying verified statement must disclose any potential conflicts of interest. Professionals should err on the side of full disclosure since the sanctions for failing to disclose fully and properly all connections include disqualification from representation and denial of compensation. *See In re Granite Sheet Metal Works, Inc.*, 159 B.R. 840, 847-48 (Bankr. S.D. Ill. 1993) (disqualification of counsel and disgorgement of fees were appropriate where attorneys failed to disclose the extent of their pre-petition representation of the debtor).

2. <u>Official Committee's Retention of Professionals Under 11 U.S.C. § 1103</u>

Section 1103 authorizes an official creditors' committee to employ counsel and other professionals provided that the professionals who are employed may not, while employed by the committee, "represent any other entity having an adverse interest in connection with the case."

Section 1103(b) does not disqualify a professional person from representing a committee appointed under section 1102 solely because the professional holds an interest adverse to the estate or is not disinterested under section 101(14). *See In re Enron Corp.*, 2002 WL 32034346 (Bankr. S.D.N.Y. 2002).

3. <u>Counsel's Solicitation of Unsecured Creditors Committee Representation</u>

The appointment as counsel to the official committee of unsecured creditors brings with it many ethical concerns. However, these concerns are not just limited to post-retention matters; the conduct of the lawyer or law firm must be considered from the moment that the decision is made for the firm or lawyer to pursue the representation of the particular committee. Attorneys must consider the rules of ethics when soliciting potential members of the committee for retention as counsel, or risk facing disciplinary action.

- **QUERY**: Can counsel seeking to be engaged by the committee (i) "cold call" committee members?; (ii) advertise directly to committee members?; (iii) take committee members to dinner?; or (iv) otherwise court the committee to obtain the engagement?

MRPC 7.1 through 7.4 are implicated when considering solicitation or advertising by an attorney. While the Model Rules do not prohibit solicitation or advertising through written, recorded or electronic communication, s*ee* Model Rule 7.2(a), lawyers are specifically prohibited from making a pitch to a potential client in person, over the telephone, or through e-mail unless certain exceptions apply. *See* Model Rule 7.3. The exceptions are: (i) the person contacted is a lawyer; OR (ii) the person contacted has a family, close personal, or prior professional relationship with the lawyer.

Based on the Model Rules, contacting a former client to express an interest in being appointed as counsel would not constitute an ethical violation; however, under the Model Rules, "cold-calling" a prospective committee member may constitute an ethical violation, for which the lawyer/law firm may be held accountable.

If Model Rule 7.3(a) is read literally, it could provide a way around the prohibition against contacting non-clients because the prospective committee member is not itself the prospective client. A literal reading of Model Rule 7.3 could be used to argue that a lawyer could make a written "pitch" for professional employment to a potential committee member that is not a client or former client (so long as there is no material misrepresentation or materially misleading information).

Model Rule 7.2(b) provides that "[a] lawyer shall not give anything of value to a person for recommending the lawyer's legal services." Thus, a lawyers are probably violating Model Rule 7.2(b) when they buy dinner or drinks or provide free seminars and/or advice to a potential committee member for the sole purpose of having the person recommend them for the position of committee counsel.

C. Fiduciary Duties of Debtor's Counsel

Counsel to an entity in the zone of insolvency, the debtor in possession ("DIP"), or a trustee owe extensive fiduciary duties to their clients, as defined by the Bankruptcy Code (and related case law), the Model Rules of Professional Responsibility, and applicable state law. *See ICM Notes, Ltd. v. Andrews & Kurth, LLP*, 278 B.R. 117, 126 (S.D. Tex. 2002); *Hansen, Jones & Leta, P.C. v. Segal*, 220 B.R. 434, 465 (D. Utah 1998); *In re Sidco, Inc.*, 173 B.R. 194, 196 (E.D. Cal. 1994).

Debtor's counsel has extensive duties, including (but not limited to): (i) <u>Duty of Loyalty</u> - *In re R&R Associates of Hampton,* 402 F.3d 257, 266 (1st Cir. 2005) (This duty is also owed to a creditors' committee by a lawyer retained to represent the committee); *Hansen, Jones & Leta, P.C. v. Segal*, 220 B.R. 434, 454 (D. Utah 1998) (The duty of loyalty includes the duty to maintain the confidentiality of the client and the duty to prevent any conflict of interest.); (ii) <u>Duty to Inform of DIP's Violation of its Fiduciary Duty to Estate and Beneficiaries</u> – *In re JLM, Inc.*, 210 B.R. 19, 26 (2d Cir. BAP 1997); *In re Sky Valley Inc.*, 135 B.R. 925, 937-38 (Bankr. N.D. Ga. 1992) (duty to disclose DIP's unauthorized use of estate funds); (iii) <u>Duty to "Police" the Debtor</u> – *In re Dieringer*, 132 B.R. 34 (Bankr. N.D. Cal. 1991); (iv) <u>Duty to Maximize Estate Assets</u> – *In re Keene Corp.*, 205 B.R. 690, 691 (Bankr. S.D.N.Y. 1997).

D. Fiduciary Duties of Committee Counsel

1. Scope of Fiduciary Duty

Counsel for an creditors committee of unsecured creditors owes a fiduciary duty to all unsecured creditors. *In re General Homes Corp.*, 181 B.R. 87 (Bankr. S.D. Tex. 1994).

2. Duties of Access to Information and Solicitation of Comments

The BAPCPA amended 11 U.S.C. § 1102(b)(3) to provide:

> A committee appointed under subsection (a) shall-
>
> (A) provide access to information for creditors who-
>
> (i) hold claims of the kind represented by that committee; and
>
> (ii) are not appointed to the committee;
>
> (B) solicit and receive comments from the creditors described in subparagraph (A); and
>
> (C) be subject to a court order that compels any additional report or disclosure to be made to the creditors described in subparagraph (A).

Prior to the BAPCPA, it was established that the appointed creditors' committee held an attorney-client privilege with its attorney. *See*, *e.g.*, *In re Subpoenas Duces Tecum Dated March 16, 1992*, 978 F. 2d 1159 (9th Cir. 1992); *In re JMP Newcor Intern. Inc.*, 204 B.R. 963 (Bankr. N.D. Ill. 1997); *Matter of Baldwin United Corp.*, 38 B.R. 802 (Bankr. S.D. Ohio 1984).

3. Effect of the BAPCPA

The committee is now required to provide all non-committee member constituents with access to information.

The committee is now required to solicit and receive comments from their non-committee member constituents.

The committee may now be subject to a court order that compels additional reports or disclosures to creditors represented by the Committee, but are not members of the Committee.

The flow of information and discovery between a debtor and the creditors' committee may be stalled as a result of the committee's requirement to provide information to its non-committee member constituents. Committees may not be as willing to enter into confidentiality agreements with a debtor because they cannot guarantee that the information received from the debtor will remain confidential if a non-committee member creditor seeks information from the committee. As a result of the disclosure requirement, debtors may choose not to participate in an open exchange of information with the committee until such time as the court has entered an order stating that the committee is not required to provide confidential information to its non-member constituents, or another agreement has been reached that is acceptable to both the debtor and the committee.

Courts will be required to address the competing policy interests in terms of the disclosure of the information to those creditors who are not on the creditors' committee.

- *In re REFCO, Inc.*, 336 B.R. 187 (Bankr. S.D.N.Y. 2006)

The United States Bankruptcy Court for the Southern District of New York issued an opinion regarding the requirement of the committee to disclose information to its non-member constituents pursuant to 11 U.S.C. § 1102(b)(3). The court held that the committee would not be required to disclose confidential and non-public, proprietary, privileged, and other protected information, without further court order; *however*, with respect to all other information, the committee would be required to proactively provide specified types of information on a committee-run website. The court also established a protocol for handling disputes between the committee and its non-member constituents regarding information requested by the non-member creditor.

- *In re FLYi, Inc., et al.*, Case No. 05-20011 (Bankr. D. Del. 2005)

In the Independence Air bankruptcy case, the Debtors proactively filed a motion seeking the entry of an order providing that any creditors' committee appointed pursuant to 11 U.S.C. § 1102 is not authorized or required pursuant to 11 U.S.C. § 1103(b)(3)(A) to provide access to the debtors' confidential information or to provide privileged information to any creditor that the committee represents. Only after the United States trustee had appointed an official committee did the court grant the motion, defining confidential information and privileged information (for the purposes of the order) and expressly stating what did not constitute "confidential information" under the order. The court specifically held that the committee was not required to utilize a website to disseminate information to its constituency or to respond to inquiries and comments received from them. The court also stated that the committee was to use its "reasonable business judgment" in responding to such inquiries and comments.

APPLICABILITY OF ATTORNEY-CLIENT PRIVILEGE

A. "Noisy" Withdrawal - Is Counsel for the Debtor In Possession Required to Inform the Court of Misbehavior by Management?

An attorney may not reveal the client's confidential information, and certainly must prevent disclosure of matters within the attorney-client privilege. *See* ABA Model Rules of Professional Conduct ("MRPC") 1.6. Moreover, the duty of undivided loyalty is part of the fiduciary duties owed by attorneys to the clients. As a result, professionals face an ethical dilemma when the officers running the debtor are corrupt.

There are certain exceptions to the rules of confidentiality and the attorney-client privilege, which may alleviate ethical problems posed by a misbehaving client.

- In a <u>non-litigation context</u>, if the client requests the lawyer to disclose confidential information that the lawyer knows is false, the lawyer is required to advise the client that the representation will be terminated if the client further insists upon the lawyer's using the false information. *See* MRPC 1.16 (authorizing withdrawal of counsel where counsel knows client is contemplating criminal activity). If the client proceeds with committing the fraud, the lawyer must terminate the representation, but cannot disclose the confidential information. If the lawyer believes that the client is continuing to perpetuate a fraud, counsel may additionally need to disavow any opinions or other documents he may have provided to third parties. The scope of the withdrawal and disavowal is subject to various interpretations. *See, e.g., In re O.P.M. Leasing Servs., Inc.*, 13 B.R. 64 (S.D.N.Y. 1981).

- In a <u>litigation matter</u>, counsel also has options to overcome ethical issues when they arise. The attorney is prohibited from: (1) making a false statement of material fact or law to a tribunal; (2) failing to disclose a material fact to a tribunal when disclosure is necessary to avoid assisting a criminal or fraudulent act by the client; (3) offering evidence that the attorney knows to be false. *See* MRPC 3.3. Thus, where the client does not take steps to rectify its improper actions, the attorney may withdraw from the representation. *See* MRPC 1.16(a)(1) (requiring an attorney to withdraw from representing a client "if the representation will result in violation of the Rules of Professional Conduct or other law"). If the prospective ethical issue involves perjury or a fraud on the court, the attorney has an obligation to "rat" on his client. *See Nix v. Whiteside*, 475 U.S. 157, 168-69 (1986) ("[There is a] special duty of an attorney to prevent and disclose frauds upon the court.").

Where a client refuses to correct the false testimony or disclose the fraud, a "noisy" withdrawal may be permitted. A noisy withdrawal is a withdrawal from the representation of a client accomplished by a disavow of work product provided by the attorney. *See* ABA Formal Opinion 92-366. An attorney can make a noisy withdrawal only if the attorney's work product is being used or is intended to be used in a *future* fraud or future criminal activity. Counsel may accomplish a noisy withdrawal by immediately moving to withdraw from the representation upon the discovery of the fraud and the failure of the debtor to rectify such fraud.

After withdrawing from a case, a lawyer is required to take reasonable steps to protect the client's interests, including (a) giving the client reasonable notice of withdrawal; (b) allowing the client time to employ replacement counsel; (c) cooperating with replacement counsel; (d) returning property and papers that belong to the client; and (e) refunding any unearned advance fees. *See* MRPC 1.16(d).

- *In re The Phoenix Group Corp.*, 305 B.R. 447 (Bankr. N.D. Tex. 2003)

Chapter 11 debtors' counsel represented the debtors in a hotly-contested chapter 11 proceeding. Counsel for the debtors moved twice to be permitted to withdraw for ethical reasons. In one of the motions counsel noted that the debtors' principal was demanding that debtors' counsel take actions and pursues strategies that counsel found to be "legally and ethically improper. The second motion to withdraw was granted. Counsel ultimately filed a final fee application and the principals of their former client, allegedly on behalf of the debtors, objected arguing (1) the debtors' counsel failed to properly object to the plan of another related chapter 11 debtor (the "Related Case"); and (2) the debtors' counsel failed to pursue the appointment of a trustee in the Related Case. The court overruled the objection after finding that: (i) the debtors could not get along with any attorney, as six of its 20 largest creditors were law firms; (ii) the debtors did in fact attempt to require their counsel take improper actions; and (iii) the debtors' counsel properly exercised its professional judgment in deciding not to pursue the actions which were the basis of objection to the fee application.

B. Difficult "Noisy" Withdrawal Questions

When misbehavior by management of the debtor is more subtle, such as questionable expenditures, counsel's decision whether to inform is more difficult. In a chapter 11 case the debtor in possession's attorney represents a client that has attributes of both a fiduciary (a trustee) and a self-interested litigant (a debtor and a party in interest). The common law fiduciary duties of care and loyalty impose standards of conduct on all agents for the debtor. Attorneys are included in the list of agents having fiduciary duties. As such, one of the fiduciary duties that estate counsel has in a bankruptcy case is the duty to report improper conduct by the DIP and its management to the Bankruptcy Court or other authorities. *See Zeisler & Zeisler v. Prudential Ins. Co. (In re JLM, Inc.)*, 210 B.R. 19, 26 (2d Cir. 1997); *In re Bonneville Pacific Corp.*, 196 B.R. 868, 886-88 (Bankr. D. Utah 1996); *Coldwell Banker Residential Real Estate v. Berner*, 609 N.Y.S.2d 948, 951 (N.Y. App. Div. 1994) (an agent breaches his fiduciary duty of loyalty "by failing to disclose information obtained during the period of engagement which affects a transaction in which the agent is engaged, so that the principal may take steps to protect his or her interests."); *see also In re Brennan*, 187 B.R. 135, 150 (Bankr. D.N.J. 1995) (noting that professionals will be obligated to report Debtor's breach); *In re Fivers*, 167 B.R. 288, 301 (Bankr. N.D. Ga. 1994) (noting that attorney, as fiduciary of estate, must further estate's interest); *In re Barrie Reed Buick-GMC Inc.*, 164 B.R. 378, 381 (Bankr. S.D. Fla. 1984) (noting the duty of debtor's counsel to bring breaches of fiduciary to attention of court). *See generally In re Love*, 163 B.R. 164 (Bankr. D. Mont. 1993); *In re Granite Sheet Metal Works Inc.*, 159 B.R. 840 (Bankr. S.D. Ill. 1993); *In re United Utensils Corp.*, 141 B.R. 306 (Bankr. W.D. Pa. 1992); *In re Wilde Horse Enterprises Inc.*, 136 B.R. 830 (Bankr. C.D. Cal. 1991); *In re Sky Valley Inc.*, 135 B.R. 925 (Bankr. N.D. Ga. 1992); *In re Rusty Jones Inc.*, 134 B.R. 321 (Bankr. N.D. Ill. 1991).

One of the first cases to discuss estate counsel's duty to report wrongdoing on the part of the DIP was *In re Rusty Jones Inc.*, 134 B.R. 321 (Bankr. N.D. Ill. 1991) where the court denied 60% of the requested fees of estate counsel due to numerous violations of counsel's fiduciary duty, including counsel's failure to inform the court of clear insider misconduct relating to the post-petition operation of the estate's business. Since *Rusty Jones*, opinions have considered this question and have held that estate counsel has breached, or would breach, the fiduciary duty by failure to disclose.

Estate counsel could make a noisy withdrawal in cases involving serious client misconduct. But what if the judge doesn't permit the withdrawal of representation? Or what if the judge asks “why”?

Requiring attorneys for debtors in possession to inform on their clients raises several issues. The first issue is whether the attorney has any discretion to determine the seriousness of the misconduct. The second issue concerns disagreements over estate administration. A decision to sell or retain business assets is affected by whether the person making the decision believes in the viability of the business. Is a debtor in possession who believes, despite continuing losses, that a business can be turned around, breaching a fiduciary duty, thus triggering counsel's obligation to inform the court? A third issue concerns the adversarial process itself. All other parties in the adversarial process are entitled to rely on their counsel's protecting their confidential information.

BAPCPA’S NEW DRA DISCLOSURE REQUIREMENTS: 11 U.S.C. § 527(a)(2)

A. Overview

BAPCPA has established considerable restrictions on the activities of debt relief agencies (“DRA”). *See* 11 U.S.C. §§ 526, 527 and 528. It requires DRAs who render "bankruptcy assistance" to enter written contracts with "assisted persons," disclose the extent of services provided and fees charged, and disclose clearly and conspicuously in all advertising that their services contemplate bankruptcy. *See* 11 U.S.C. § 528. It also requires DRAs to provide a detailed written notice to all "assisted persons" of the disclosure requirements of the Bankruptcy Code, the obligation of accuracy and truthfulness on those disclosures, and that failure to comply with those requirements carries potential civil and criminal sanctions. *See* 11 U.S.C. § 527. DRAs are prohibited from failing to provide the services they contracted to provide, counseling any person to make false statements, or advising the 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[.]" *See* 11 U.S.C. § 526(a)(4).

The disclosures under section 527 appear to be required in consumer cases only (rather than in business cases). "Debt relief agency" is defined in section 101(12A) as "any person who provides any 'bankruptcy assistance' to an assisted person in return for the payment of money or other valuable consideration or who is a bankruptcy petition preparer." "Assisted person" is defined in new section 101(3) as "any person whose debts consist primarily of consumer debts and the value of whose nonexempt property is less than $150,000." Therefore, DRAs who represent owners of businesses and individuals whose nonexempt property is greater than $150,000 would not be covered.

- **QUERY**: Is a bankruptcy lawyer a debt relief agency under BAPCPA? The definition in section 101 seems broad enough to include attorneys; however, at least one court has issued a *sua sponte* ruling determining that attorneys are not "debt relief agencies" as that term is used in BAPCPA. *See In re Attorneys at Law and Debt Relief Agencies*, 332 B.R. 66 (Bankr. S.D. Ga. 2005). *But see In re McCartney*, 336 B.R. 588 (Bankr. M.D. Ga. 2006) (Attorney moved for determination that attorneys practicing before bankruptcy court were not "debt relief agencies," and were not subject to obligations imposed on debt relief agencies under BAPCPA; however, bankruptcy court held that motion did not present live "case or controversy," over which it could exercise jurisdiction.).

B. DRA Disclosure Requirements -- 11 U.S.C. § 527

1. Statutory Text

Section 527(a)(2) requires DRAs to tell their clients about the dangers of bankruptcy and to explain bankruptcy alternatives. These disclosures must be made no later than three days after bankruptcy assistance is first offered to the debtor. Specifically, section 527(a)(2) sets forth a series of "disclosures" which DRAs must provide to all assisted persons being provided bankruptcy assistance (which would include creditors). Significantly, section 526(c) authorizes the Court to impose civil liability for violation of duties imposed upon debt relief agencies.

11 U.S.C. § 527 provides (emphasis added):

> (a) A debt relief agency providing bankruptcy assistance to an assisted person shall provide—
>
> (1) the written notice required under section 342(b)(1) [11 USC § 342(b)(1)]; and

(2) to the extent not covered in the written notice described in paragraph (1), and not later than 3 business days after the first date on which a debt relief agency first offers to provide any bankruptcy assistance services to an assisted person, a clear and conspicuous written notice advising assisted persons that—

(A) all information that the assisted person is required to provide with a petition and thereafter during a case under this title is required to be complete, accurate, and truthful;

(B) all assets and all liabilities are required to be completely and accurately disclosed in the documents filed to commence the case, and the replacement value of each asset as defined in section 506 [11 USC § 506] must be stated in those documents where requested after reasonable inquiry to establish such value;

(C) current monthly income, the amounts specified in section 707(b)(2) [11 USC § 707(b)(2)], and, in a case under chapter 13 of this title [11 USC §§ 1301 et seq.], disposable income (determined in accordance with section 707(b)(2) [11 USCS § 707(b)(2)]), are required to be stated after reasonable inquiry; and

(D) information that an assisted person provides during their case may be audited pursuant to this title, and that failure to provide such information may result in dismissal of the case under this title or other sanction, including a criminal sanction.

(b) A debt relief agency providing bankruptcy assistance to an assisted person shall provide each assisted person at the same time as the notices required under subsection (a)(1) the following statement, to the extent applicable, or one substantially similar. The statement shall be clear and conspicuous and shall be in a single document separate from other documents or notices provided to the assisted person:

"IMPORTANT INFORMATION ABOUT BANKRUPTCY ASSISTANCE SERVICES FROM AN ATTORNEY OR BANKRUPTCY PETITION PREPARER.

"If you decide to seek bankruptcy relief, you can represent yourself, you can hire an attorney to represent you, or you can get help in some localities from a bankruptcy petition preparer who is not an attorney. THE LAW REQUIRES AN ATTORNEY OR BANKRUPTCY PETITION PREPARER TO GIVE YOU A WRITTEN CONTRACT SPECIFYING WHAT THE ATTORNEY OR BANKRUPTCY PETITION PREPARER WILL DO FOR YOU AND HOW MUCH IT WILL COST. Ask to see the contract before you hire anyone.

"The following information helps you understand what must be done in a routine bankruptcy case to help you evaluate how much service you need. Although bankruptcy can be complex, many cases are routine.

"Before filing a bankruptcy case, either you or your attorney should analyze your eligibility for different forms of debt relief available under the Bankruptcy Code and which form of relief is most likely to be beneficial for you. Be sure you understand the relief you can obtain and its limitations. To file a bankruptcy case, documents called a Petition, Schedules and Statement of Financial Affairs, as well as in some cases a Statement of Intention need to be prepared correctly and filed with the bankruptcy court. You will have to pay a filing fee to the bankruptcy court. Once your case starts, you will have to attend the required first meeting of creditors where you may be questioned by a court official called a 'trustee' and by creditors.

"If you choose to file a chapter 7 case, you may be asked by a creditor to reaffirm a debt. You may want help deciding whether to do so. A creditor is not permitted to coerce you into reaffirming your debts.

"If you choose to file a chapter 13 case in which you repay your creditors what you can afford over 3 to 5 years, you may also want help with preparing your chapter 13 plan and with the confirmation hearing on your plan which will be before a bankruptcy judge.

"If you select another type of relief under the Bankruptcy Code other than chapter 7 or chapter 13, you will want to find out what should be done from someone familiar with that type of relief.

"Your bankruptcy case may also involve litigation. You are generally permitted to represent yourself in litigation in bankruptcy court, but only attorneys, not bankruptcy petition preparers, can give you legal advice.".

(c) Except to the extent the debt relief agency provides the required information itself after reasonably diligent inquiry of the assisted person or others so as to obtain such information reasonably accurately for inclusion on the petition, schedules or statement of financial affairs, a debt relief agency providing bankruptcy assistance to an assisted person, to the extent permitted by nonbankruptcy law, shall provide each assisted person at the time required for the notice required under subsection (a)(1) reasonably sufficient information (which shall be provided in a clear and conspicuous writing) to the assisted person on how to provide all the information the assisted person is required to provide under this title pursuant to section 521 [11 USC § 521], including—

(1) how to value assets at replacement value, determine current monthly income, the amounts specified in section 707(b)(2) [11 USC § 707(b)(2)] and, in a chapter 13 case, how to determine disposable income in accordance with section 707(b)(2) [11 USC § 707(b)(2)] and related calculations;

(2) how to complete the list of creditors, including how to determine what amount is owed and what address for the creditor should be shown; and

(3) how to determine what property is exempt and how to value exempt property at replacement value as defined in section 506 [11 USC § 506].

(d) A debt relief agency shall maintain a copy of the notices required under subsection (a) of this section for 2 years after the date on which the notice is given the assisted person.

2. Analysis of DRA Disclosure Requirements

First, under section 527(a)(1), the assisted person must be given the written notice required under section 342(b)(1) (despite the fact that section 342 requires this notice to be given by the clerk of the court). Section 527 only mentions a portion of the notice required under section 342 (evidently omitting the portion required by section 342(b)(2)).

Second, section 527(a)(2) provides that to the extent not covered by the section 342(b)(1) notice, and within 3 days of when the DRA first offers to provide bankruptcy assistance services to an assisted person (including a creditor or landlord) a clear and conspicuous notice containing various other pieces of information (which is reprinted in section 527) must also be provided. For example, the notice is to inform the debtor that replacement value of each asset as defined in section 506 must be stated where requested in the "documents filed to commence the case" after reasonable inquiry to establish that value. Note however that the document filed to commence the case is the petition, which requires no property valuation; consequently, the required statement may be misleading.

Third, section 527(b) states that a DRA must provide the assisted person a statement about "bankruptcy assistance services." This statement must be provided at the time of notice under section 527(a)(1) (but no time requirement is set in section 527(a)(1), which refers to the clerk's notice under section 342(b)(1)). Under section 342, the clerk is required to give its notice before commencement of the case.

- **QUERY:** If a creditor who is an assisted person first consults an attorney after the commencement of the case, is it impossible for the attorney to give timely notice to the creditor? Could this cause attorneys to refuse to accept an engagement because they cannot comply with the provision?

Thus, it appears that the following disclosures/notices must be given to all assisted persons being provided bankruptcy assistance under BAPCPA:

- Notice mandated by section 342(b)(1) and section 527(a)(1) – purposes, benefits and costs of bankruptcy.

- Notice mandated by section 527(a)(2) – notice of mandatory disclosure to consumers who contemplate filing bankruptcy.

- Notice mandated by section 342(b)(2) – notice that fraud and concealment are prohibited.

- Notice mandated by section 527(b) – information about bankruptcy assistance services.