WHY YOUR MALPRACTICE PREMIUMS KEEP GOING UP

Current Ethical Issues For Attorneys And Non-Lawyer Professionals In Bankruptcy Cases

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Current Ethical Issues For Attorneys And Non-lawyer Professionals In Bankruptcy Cases

I. Disclosure and Disinterestedness

Unsurprisingly, many of the decisions in which professionals are taken to task in bankruptcy cases involve the intersection of potential conflicts and lack of disclosure.

A. Disinterestedness-General Considerations

At the outset, determination of potential conflicts may be a complex undertaking in a large Chapter 11 proceeding. However, the consequences of the failure to check for conflicts in connection with bankruptcy cases cannot be overstated. In undertaking representation, particularly in chapter 11 cases, counsel must meet the requirements of section 327 of the Code, which specifically proscribe conflicts of interest.[2] Section 327 sets forth a two-part test to determine whether an attorney may act as counsel for the debtor: (i) counsel may not represent any interest materially adverse to the estate, and (ii) counsel must be disinterested. The requirements are distinct although courts often confuse them. The "adverse interest" requirement is a fairly familiar conflict rule that applies to all lawyers.[3] The "disinterestedness" requirement is a term of art defined in section 101(14).

In business reorganization cases, these problems of real (or potential) divided loyalties arise in a number of contexts. Among the more common ethical problems of divided loyalty are: (i) simultaneous representation of multiple creditors in the same case;[4] (ii) representation of a creditor or creditors and an official creditors committee;[5] (iii) simultaneous or successive representation of a creditor and the debtor in the same case;[6] (iv) representation of the debtor in the bankruptcy case and of the creditor(s) of the debtor in other unrelated cases or on unrelated

[2] See 11 U.S.C. § 327 (a) (1994) "[T]he duty explicitly imposed on the bankruptcy court by § 327 . . . demands that the court root out all impermissible conflicts of interest between attorney and client." In re Martin, 817 F.2d 175, 180 (1st Cir. 1987). Code section 327 mandates all appointed attorneys "tender undivided loyalty and provide untainted advice and assistance in furtherance of their responsibilities." Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir. 1994); see also In re Grabill Corp., 113 B.R. 966, 970 (Bankr. N.D. Ill. 1990) (noting "[c]ounsel for a chapter 11 debtor owes a fiduciary duty to the corporation or partnership as an entity").

[3] See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7 (1983).

[4] See, e.g., City of Lafayette v. Oklahoma P.A.C. First Ltd. Partnership (In re Okla. P.A.C. First Ltd. Partnership), 122 B.R. 387, 389-94 (Bankr. D. Ariz. 1990) (considering simultaneous representation of five individual creditors).

[5] See, e.g., In re Calabrese, 173 B.R. 61, 63 (Bankr. D. Conn. 1994) (sustaining trustee's objection to application of official unsecured creditors' committee seeking retroactive employment of counsel where counsel represented secured creditors on unrelated matters).

[6] See, e.g., Humble Place Joint Venture v. Fory (In re Humble Place Joint Venture), 936 F.2d 814, 818-19 (5th Cir. 1991) (considering simultaneous representation of creditor and debtor in same bankruptcy proceeding).

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matters;[7] (v) payment of debtor counsel fees by a third party;[8] (vi) representation of multiple affiliates;[9] (vii) the problem created by the necessity that counsel for a corporate debtor take its direction from management, which itself may not be governed by the disinterestedness requirement; (viii) simultaneous representation of two unsecured creditors' committees of economic competitors;[10] and (ix) representing a creditor and the trustee (as special counsel).[11] The issue underlying each of these considerations is whether the court in fact looks to actual conflicts or potential conflicts.

[7] See, e.g., In re American Printers & Lithographers, Inc., 148 B.R. 862, 867 (Bankr. N.D. Ill. 1992) (denying debtor's application to employ counsel where counsel's representation of creditor in other matters created actual conflict requiring disqualification); In re Amdura Corp., 121 B.R. 862, 863-64 (Bankr. D. Colo. 1990) (considering counsel's representation of six debtor entities and counsel's former and successive representation, albeit on unrelated matters, of principal creditor); In re Status Game Corp, 102 B.R. 19, 21 (Bankr. D. Conn. 1989) (denying debtor's application to retain its regular prepetition counsel where counsel represented debtor's principal secured creditor both prepetition and postpetition); In re Lee Way Holding Co., 100 B.R. 950, 962 (Bankr. S.D. Ohio 1989) (granting creditor's motion to disqualify debtor's counsel and require disgorgement of fees where counsel represented creditor prepetition and continued professional relationship postpetition).

[8] See, e.g., In re Rabex Amuru, Inc., 198 B.R. 892, 897-98 (Bankr. M.D.N.C. 1996) (granting motion to remove debtor's counsel where firm's fees paid by creditor); In re Missouri Mining, Inc., 186 B.R. 946, 950 (Bankr. W.D. Mo. 1995) (denying trustee's motion to vacate order authorizing employment of debtor's counsel where counsel's retainer was paid by debtor's principal, who was also a creditor, because counsel found disinterested); In re Hathaway Ranch Partnership, 116 B.R. 208, 219 (Bankr. C.D. Cal. 1990) (finding payment of debtor's counsel by third party creates actual conflict of interest warranting disqualification); In re Crimson Invs., N.V., 109 B.R. 397, 403 (Bankr. D. Ariz. 1989) (ordering surrender of entire retainer received by debtor's counsel where retainer paid by debtor's largest unsecured creditors).

[9] See, e.g., W.F. Dev. Corp. v. Office of United States Trustee (In re W.F. Dev. Corp.), 905 F.2d 883, 884 (5th Cir. 1990) (concluding simultaneous representation of general partner and limited partners creates incurable conflict of interest), cert. denied, 499 U.S. 921 (1991); In re Renfrew Ctr. Inc., 195 B.R. 335, 342 (Bankr. E.D. Pa. 1996) (granting application of two related corporate debtors to retain same law firm as counsel in respective chapter 11 cases where no impermissible conflict of interest found); In re Interstate Distribution Ctr. Assocs. (A), Ltd., 137 B.R. 826, 834-35 (Bankr. D. Colo. 1992) (finding counsel's representation of corporate debtor and its related entities created impermissible conflict of interest precluding law firm's employment as debtor's counsel).

[10] See, e.g., In re Caldor, Inc., 193 B.R. 165, 181-82 (Bankr. S.D.N.Y. 1996) (overruling trustee's motion objecting to law firm's retention by creditors' committee where counsel simultaneously represented creditors' committee in chapter 11 case of debtor's competitor).

[11] See, e.g., In re Durbin, 205 B.R. 17 (Bankr. D.N.H. 1997) where attorneys fees were reduced by 40%. After negotiating an agreement to have certain disputed assets surrendered to the estate, the attorney attached other disputed assets solely for the benefit of his unsecured creditor client. The representation was simultaneous for a few weeks and his fees were reduced as a result of his undisclosed conduct and the question of whether the attached assets could have gone to the estate for all creditors.

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B. Actual Versus Potential Conflicts ("Let's wait and see what happens")

Under the Bankruptcy Code, as in other areas of law, attorneys are not allowed to represent a person when there are conflicts, unless the clients have agreed to such representation.[12]

A number of courts that have struggled with the practicalities and potential inefficiencies of multiple lawyers representing closely affiliated entities have fashioned a distinction between actual and potential conflicts.[13] Other courts have determined that such a distinction is unrealistic.

In In re Kendavis Industries International,[14] the court rejected the notion that counsel ceases to be disinterested only when a potential conflict becomes actual. The court held that a conflict is present "whenever counsel for a debtor corporation has any agreement, express or implied, with management or a director of the debtor, or with a shareholder, or with any control party, to protect the interest of that party." The Kendavis court saw the concept of "potential" conflicts as "a contradiction in terms," noting that "[o]nce there is a conflict it is *actual—not potential*."[15]

The fallacy of a distinction between actual and potential conflicts was illustrated in In re BH & P, Inc.,[16] where the court rejected the notion that actual and potential conflicts should be treated differently. Pointing out that a potential conflict could "exert a subtle influence over the manner in which events develop to set the stage for an active competition," the court emphasized that by the time a so-called "potential conflict" becomes "actual," the damage might be done already.

As a caveat, attorneys should recognize that waiting until an "actual" conflict appears can cause severe economic consequences. In Leslie Fay, 175 B.R. 525 (Bankr. S.D.N.Y. 1994) for example, the law firm's failure to disclose potential and actual conflicts reportedly cost the firm approximately $1 million.

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[12] See 11 U.S.C. § 327 and MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7 (a) (1983). Further, the lawyer may only represent a client whose interests are "materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests" after each client has consented after consultation.

[13] See, e.g., In re Global Marine, Inc., 108 B.R. 998, 1002 (Bankr. S.D. Tex. 1987) (finding that while dual representation might rise to level of potential conflict; it does not, in and of itself, reach the disqualifying level of actual conflict); In re Martin, 817 F.2d at 181 (reasoning that while actual conflict will generally be disabling, no such per se rule may be applied where mere potential conflict exists).

[14] In re Kendavis Indus. Int'l, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988).

[15] See id. (emphasis added); see also In re Global Marine, Inc., 108 B.R. 998, at 1006-07 (Bankr. S.D. Tex. 1987) (requiring actual conflict and therefore allowing law firm to represent parent holding company and subsidiaries despite existence of intercompany debt); In re Philadelphia Athletic Club, Inc., 20 B.R. 328, 337-38 (Bankr. E.D. Pa. 1982) (disqualifying all members of law firm even though no actual conflict of interest).

[16] 103 B.R. 556 (Bankr. D.N.J. 1989), aff'd, 949 F.2d 1300 (3d Cir. 1991).

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As one court described the terms "actual" and "potential" as merely "different stages in the same relationship."[17] While an actual conflict can be defined as "an active competition between two interests in which one interest can only be served at the expense of the other," a potential conflict is "one in which the competition is presently dormant, but may become active if certain contingencies occur."

C. Selected Problems

1. May the Same Attorney or Law Firm Represent Multiple Creditors in a Bankruptcy Case?

The Model Rules of Professional Conduct and the case law, [18] not the Bankruptcy Code, governs representation of multiple creditors.[19] With the exception of the Rule 2019[20] requirements regarding disclosure of multiple representations, the professional conduct rules rather than the Bankruptcy Code regulate the representation of multiple creditors. Model Rule of Professional Conduct 1.7 recognizes that there is no inherent ethical conflict in a lawyer representing more than one creditor in a bankruptcy case, so long as the dual representation is disclosed, clients are informed about possible implications of the dual representation, and each client consents. Consultation contemplates explaining to each client the implications, risks, and possible adverse consequences of the common representation. All the clients must consent. An attorney making the decision to represent more than one entity in connection with the bankruptcy case should carefully balance any risks to each client against the benefits and efficiencies of multiple representation. Only where the risks are minimal should dual representation be undertaken. Obviously, if the parties have potentially conflicting positions (such as one creditor being secured and the other unsecured) dual representation should not be undertaken.[21]

The attorney should specifically inform each client of the circumstances under which counsel will be required to explain the reasons for a termination of representation. For example, communication from each client is privileged and confidential as to that client and could not be disclosed to the other in the context of explaining the reasons for withdrawal.[22]

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[17] BH & P, 103 B.R. at 563.

[18] See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7 (1983).

[19] See In re Star Broad., Inc., 81 B.R. 835, 837-39 (Bankr. D.N.J. 1988) (stating courts rely on § 327(a) standards, case law interpreting that section, and rules of professional conduct to determine whether a conflict of interest exists) (citing *In re* Philadelphia Athletic Club, Inc., 20 B.R. 328, 335-36 (E.D. Pa. 1982); In re Roberts, 46 B.R. 815, 837-38 (Bankr. D. Utah 1985), aff'd in part, rev'd and vacated in part on other grounds, 75 B.R. 402 (D. Utah 1987); In re Chou-Chen Chems., Inc., 31 B.R. 842, 849-52 (Bankr. W.D. Ky. 1983)).

[20] FED. R. BANKR. P. 2019 (detailing requirements for representation of creditors or equity security holders in chapters 9 and 11).

[21] See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.16 (stating when conflict of interest arises during course of representation, lawyer must withdraw). See also LaFayette v. Oklahoma P.A.C. First Ltd. Partnership (In re Oklahoma P.A.C. First Ltd. Partnership) 122 B.R. 387, 393 (Bankr. D. Ariz. 1990).

[22] See MODEL RULES OF PROFESSIONAL CONDUCT. Rule 1.7 cmt. [5] (noting there may be

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Obviously, an advance agreement with both clients is essential when an attorney is handling matters in which the two clients' interests may diverge. This agreement should specify that circumstances may occur which require counsel to withdraw without further explanation.

2. Representing a Creditor and a Creditors' Committee

In 1984, Bankruptcy Code section 1103(b) was amended to provide that representation of one or more creditors of the same class shall not per se constitute the representation of an adverse interest when determining whether an attorney to be employed by a creditors' committee has a conflict.[23] Although not a per se conflict, an attorney cannot represent creditors of different classes.[24] In In re Whitman,[25] a secured creditor with a large deficiency claim was a member of the unsecured creditors committee. The committee hired the undersecured creditor's attorney to represent the committee. On reconsideration, the court ordered that counsel either withdraw as counsel to the committee or as counsel to the undersecured creditor. The court found that while the undersecured creditor's interest as an unsecured creditor may be co-extensive with other unsecured creditors, such mutuality did not eliminate the irreconcilable conflict between secured and unsecured creditors.

3. Can Professionals Who Received Payments During the Preference Period Be "Disinterested"?

An answer to this question requires a careful analysis of the use of 327(c). In reviewing the "disinterestedness" standard, the Third Circuit decided a case where the professionals received potentially preferential transfers within ninety (90) days before the petition was filed. "We hold that when there has been a facially plausible claim of a substantial preference, the district court and/or the bankruptcy court cannot avoid the clear mandate of the statute by the mere expedient of approving retention conditional upon a later determination of the preference issue." In re Pillowtex, 304 F.3d 246, 255 (3rd Cir. 2002). The case was remanded to the court below to determine whether the professional was disqualified.

This follows the prior Third Circuit precedent of In re First Jersey Securities Inc., 180 F.3d 504 (3rd Cir. 1999) where the court ruled that a professional's receiving a preferential transfer would constitute an actual conflict of interest. In First Jersey, the court also found that the firm should be disqualified because the debtor transferred restricted stock to the firm before the bankruptcy was commenced.

The issue of who should pursue preference claims against proposed professionals was not decided in Pillowtex However, the issue appeared shortly thereafter in In re Enron Corp., slip op., 2003 WL 223455 (Bankr. S.D. N.Y.) where a motion to disqualify the counsel for the

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circumstances where impossible to make disclosure necessary to obtain consent).

[23] See also In re Rusty Jones, Inc., 107 B.R. 161, 162 (Bankr. N.D. Ill. 1989); In re Whitman, 101 B.R. 37, 38 (Bankr. N.D. Ind. 1989).

[24] See 11 U.SC. § 1103(b); see also Whitman, 101 B.R. at 39 and In re Electro-Optix, U.S.A., Inc., 130 B.R. 621, 623 (Bankr. S.D. Fla. 1991) (disqualifying committee counsel for continuing to represent unsecured creditor).

[25] 101 B.R. 37 (Bankr. N.D. Ind. 1989).

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creditors committee was litigated where the proposed counsel had received significant payments before the case was filed. The *Enron* court did not disqualify the professional for a number of reasons, including the delay in presenting the Motion and the fact that an examiner had been appointed to investigate the issue of preferential transfers. The firm's agreement to be bound by the Examiner's determination also meant that it would not be adverse to the estate since there would be no dispute. This was found to have effectively waived the adverse claim on the possible preference.

4. Simultaneous Representation of the Debtor and a Creditor in an Unrelated Case

There is nothing in the professional conduct rules which ethically prohibit an attorney from representing two clients who have claims or litigation against each other, so long as the attorney (i) does not represent opposing parties in the same or substantially related litigation, or (ii) so long as the attorney's representation of one client in one matter does not materially and adversely affect his or her representation of the other client in other matters.[26] With informed consent, clients may waive most conflicts attendant to dual representation, except that a lawyer obviously may not represent opposing parties in the same litigation.

Dual representation, even in unrelated matters, becomes considerably more complex in bankruptcy cases. The strict section 327 requirements of disinterestedness and absence of an adverse interest overlay, if they do not in fact supplant, the professional conduct rules. What may be ethically acceptable in commercial settings (e.g., waivers upon informed consent) will not necessarily pass muster under section 327.

In In re Occidental Financial Group, Inc.,[27] the court upheld the disqualification and disgorgement order against an attorney where the attorney represented affiliated debtors in simultaneous chapter 11 proceedings. The attorney also simultaneously represented the insiders of these debtors, their officers, directors and general partners. The fact that the multiple representation was not disclosed when the cases were filed made the disqualification and disgorgement relatively easy for the court to impose.[28]

Likewise, the Tenth Circuit affirmed a bankruptcy court's sua sponte disqualification of debtor's counsel where three chapter 11 debtors were controlled by one person and had intercompany claims.[29] However, the Tenth Circuit stopped short of a per se disqualification rule when one attorney represents multiple debtors in possession.

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[26] *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7 (1983).

[27] In re Occidental Financial Group, Inc., 40 F.3d 1059, 1062 (9th Cir. 1994).

[28] Occidental Fin., 40 F.3d. at 1062. See also In re Hot Tin Roof, Inc., 25 B.R. 1000 (Bankr. 1st Cir. BAP 1997) (attorney's failure to disclose relationships with insiders in another case and bring the issue to the court for determination resulted in disqualification in each case and forfeiture of any fees).

[29] See Interwest Bus. Equip., Inc. v. United States Trustee (In re Interwest Bus. Equip., Inc.), 23 F.3d 311, 318-19 (10th Cir. 1994).

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In In re Premier Farms L.C., 305 B.R. 717 (Bankr. D. Iowa 2003), the law firm (Sonnenschein) that sought to represent the debtor had, as a regular client, the debtor's principal lender. The law firm had not represented the lender with respect to the debtor. Both the debtor and the lender waived any conflicts. Upon the objection of judgment creditors, the court held that the law firm was not disinterested, and thus that the firm was ineligible to represent the debtor in possession

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5. May Debtor's Counsel be Paid by a Nondebtor Third Party?

The professional conduct rules permit a lawyer to receive payment for professional services from a person other than his client so long as the consent of the client is obtained, client confidentiality is protected, the payment will not impair the lawyer's independent professional judgment to act on behalf of the client (not the payor), and the lawyer-client relationship is not invaded by the third party payor.[30]

From time to time, an entity needing the benefit of bankruptcy relief will not have sufficient resources to pay counsel a retainer because its assets are fully encumbered. Third parties—perhaps lenders, guarantors, or shareholders—may have an incentive to advance funds to debtor's counsel when the debtor is unable to do so.

Courts are divided with respect to whether fee payments from sources other than the debtor are permitted under the Bankruptcy Code. Several courts have concluded that such payments are prohibited because the payments create a per se conflict of interest.[31] The Supreme Court has prohibited certain third party payments on the basis that the attorney should not place himself in a position where he may be required to choose between conflicting duties.[32]

Some cases have taken a less rigid approach to the problem of third party payment of counsel fees.[33] These cases reason that counsel should not be automatically disqualified by virtue of a third party payment, but that such payment should disqualify counsel only if it puts him or her in a position of actually representing an interest adverse to the estate.[34]

[30] See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8(f) (1983) (outlining conflict of interest and prohibited transactions).

[31] See In re Hathaway Ranch Partnership, 116 B.R. 208, 219 (Bankr. C.D. Cal. 1990).

[32] See Woods v. City Nat'l Bank & Trust Co., 312 U.S. 262, 268 (1941); see also In re Senior G & A Operating Co., 97 B.R. 307, 310 (Bankr. W.D. La. 1989); In re 765 Assocs., 14 B.R. 449, 451 (Bankr. D. Haw. 1981); In re Bergdog Prods., Inc., 7 B.R. 890, 892 (Bankr. D. Haw. 1980). But see In re Glenn Elec. Sales Corp., 89 B.R. 410, 416 (Bankr. D.N.J. 1988) (loaning money to principal of debtor does not equal representation of creditor), aff'd, 99 B.R. 596 (D.N.J. 1988).

[33] See David & Hagner, P.C. v. DHP, Inc., 171 B.R. 429, 437 (D.D.C. 1994) (rejecting requirement if applying to bankruptcy court for third party guarantee and allowing payment of fees), aff'd, 70 F.3d 637 (D.C. Cir. 1995); see also In re Lotus Prop. L.P., 200 B.R. 388, 394 (Bankr. C.D. Cal. 1996) (accepting less rigid approach to third party payment over per se rule actual conflict rule); In re Kelton Motors Inc., 109 B.R. 641, 658 (Bankr. D. Vt. 1989) (establishing five-part test to retain counsel paid by debtor's insiders).

[34] See In re Missouri Mining, Inc., 186 B.R. 946, 949 (Bankr. W.D. Mo. 1995) (rejecting per se rule that third party payment is actual conflict and looks to fact-specific determination of whether counsel holds interest adverse to estate). The Missouri Mining court identified four factors to determine

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On its face, merely receiving money from a third party in connection with the debtor's bankruptcy case should not constitute an interest adverse to the estate or taint the disinterestedness of counsel. The fact that a payment is made by a creditor of the debtor does not automatically equal representation of that creditor's interest.[35] Moreover, payment of fees by a sole shareholder does not equate to representation of the shareholder. Third-party payment should not, in and of itself, result in automatic disqualification.

Counsel not only must avoid representing an interest adverse to the estate, but must also be a disinterested person under section 327(a).[36] Disinterestedness, defined in section 101(14)(E), includes a "catch all" (not having an interest materially adverse to the interest of the estate by reason of any direct or indirect relationship to, connection with or interest in the debtor). An expansive definition of disinterestedness under section 101(14)(E) would probably result in disqualification of counsel who received any third-party payment because the payment came from a party who is not disinterested.

In a peculiar twist, an insider worked closely with and paid the attorneys for, involuntary petitioning creditors. In re Kingston Square Assoc., 214 B.R. 713 (Bankr. S.D.N.Y. 1997) had the control person working towards an involuntary petition against the partnership -- a step necessitated by the "bankruptcy proofing" bylaws amendments designed to prevent a bankruptcy without the consent of the director designated by the lender. The court found that the insider did work to orchestrate the filings but the case would not be dismissed as a bad faith filing.

6. Member of Law Firm Insider of Debtor

In In re Essential Therapeutics, Inc., 295 B.R. 203 (Bankr. D. Del. 2003), the court held that, where a partner in the law firm was an officer of the debtor, the entire firm is "not disinterested," and thus is precluded from representing the debtor. Contra, In re S.S. Retail Stores Corp., 211 B.R. 699 (9th Cir. BAP 1997), appeal dismissed, 163 F.3d 1230 (9th Cir. 1998)(where partner of law firm had served as officer of debtor-in-possession within two years prior to bankruptcy filing, entire firm was not disqualified from representation); In re Creative Restaurant Management, Inc., 139 B.R. 902 (Bankr. W.D. Mo 1992)(where firm hired associate who had previously served as officer of debtor, firm would not be disqualified); In re

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if third party payment is basis for disqualification: whether there was any specific advantage to the third party; whether there was any injury to the estate; whether there was prejudice to other creditors; and whether an actual conflict arising from the payment is apparent. See also Lotus, 200 B.R. at 394 (following "analytical approach" to payment of fees by third party); Kelton, 109 B.R. at 642 (rejecting per se rule since it deprives future small corporate debtors from obtaining counsel of choice).

[35] See In re Glenn Elec. Sales Corp., 89 B.R. 410, 416 (Bankr. D.N.J. 1988) (loaning money to principal of debtor does not equal representation of creditor), aff'd, 99 B.R. 596 (D.N.J. 1988); see also Glenn Elec., 99 B.R. at 597 (holding payment by 100% shareholder does not equal representation of that shareholder).

[36] See 11 U.S.C. § 327(a) (1994) (dealing with employment of professionals); see also In re Star Broad., Inc., 81 B.R. 835, 838 (Bankr. D.N.J.) (stating two-prong test to qualify counsel includes disinterestedness); In re O'Connor, 52 B.R. 892, 895 (Bankr. W.D. Okla. 1985) (requiring disinterestedness of professionals).

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Keravision, Inc., 273 B.R. 614 (2002) (law firm not per se disqualified by debtor when partner was prepetition officer of debtor). Where member of the law firm had resigned as debtor's assistant secretary, had not performed duties in that position, and would not be involved in bankruptcy proceeding, firm's employment was approved in In re Capean Wholesale, Inc., 184 B.R. 547 (N.D. Ill. 1995).

D. Importance and Consequence of Disclosure

Typically, cases involving reduction or denial of fees and/or disgorgement hinge upon the failure to adequately disclose conflicts or potential conflicts. A recent case, In re Jore Corp., 298 B.R. 703 (Bankr. D. Mont. 2003) illustrates the extreme pitfalls of failure to make required disclosures "early and often." In that case, Perkins Coie LLP represented the chapter 11 Debtor. The firm disclosed certain connections to the Debtor, its creditors and other parties in interest, and pledged to continue to undertake such review and to update its disclosures as necessary. One of the "connections" which was the subject of the initial disclosure was the fact that the firm represented Wells Fargo Bank (Debtor's secured lender) in other matters. Subsequently, the firm entered into a written conflicts waiver with Wells Fargo in which it agreed not to represent Jore in litigation directly adverse to Wells. Two days later, the firm submitted a supplemental affidavit reflecting that an oral conflict waiver had been obtained from Wells Fargo and that a written waiver would be forthcoming. Supplemental filings relative to the retention did not disclose the existence or substance of the written waiver, including the litigation exception. Ultimately, Wells Fargo extended debtor in possession financing, obtaining waivers of claims and defenses, including any right to claim §506(c) surcharge. Following complete liquidation and distribution of sale proceeds to secured creditors, the U.S. Trustee's office moved for disqualification of Perkins Coie based upon a failure to disclose the terms of the written waiver, including the litigation exception. The court granted the motion, holding that FRBP 2014 creates a mandatory disclosure requirement regardless of counsel's belief that such information is inconsequential.

> Perkins was required in its employment application to comply with Rule 2014(a). F.R.B.P. Rule 2014(a) requires that an attorney's application for employment disclose, among other things, "all of the [applicant's] connections with the debtor, creditors, [or] any other party in interest...." to assist the court in ensuring that the attorney has no conflicts of interest and is disinterested, as required by 11 U.S.C. § 327(a). In re Park-Helena Corp. ("Park-Helena"), 63 F.3d 877, 881 (9th Cir.1995), cert. denied, Neben & Starrett, Inc. v. Chartwell Financial Corp., 516 U.S. 1049, 116 S.Ct. 712, 133 L.Ed.2d 667 (1996). The Ninth Circuit in Park-Helena explained:
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> The bankruptcy court must ensure that attorneys who represent the debtor do so in the best interests of the bankruptcy estate. See In re Lincoln N. Assocs., Ltd., 155 B.R. 804, 808 (Bankr.E.D.Mass.1993); In re EWC, Inc., 138 B.R. 276, 280-81 (Bankr.W.D.Okla.1992). The court must ensure, for example, that the attorneys do not have interests adverse to those of the estate, 11 U.S.C. § 327, that the attorneys only charge for services that benefit the estate, Pfeiffer v. Couch (In re Xebec), 147 B.R.

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> 518, 523 (9th Cir. BAP 1992), and that they charge only "reasonable" fees, 11 U.S.C. § 329(b). To facilitate the court's policing responsibilities, the Bankruptcy Code and Federal Rules of Bankruptcy Procedure impose several disclosure requirements on attorneys who seek to represent a debtor and who seek to recover fees. See 11 U.S.C. § 329; Fed.R.Bankr.P. 2014 & 2016. The disclosure rules impose upon attorneys an independent responsibility. Thus, failure to comply with the disclosure rules is a sanctionable violation, even if proper disclosure would have shown that the attorney had not actually violated any Bankruptcy Code provision or any Bankruptcy Rule. [In re Film Ventures Int'l, Inc., 75 B.R. 250, 252 (9th Cir. BAP 1987)]. Park-Helena, 63 F.3d at 880.

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298 B.R. at 724-25. The court held that the requirement of Rule 2014 that all "connections" be disclosed should be broadly construed in favor of disclosure. The court concluded that where all connections are not disclosed, the court is empowered to deny payment of all fees, and order disgorgement of fees already paid, even if such nondisclosure is the result of negligence or inadvertence as opposed to fraud or willful misconduct. Id. at 729. Accord, In re Condor Systems, Inc., (Bankr. N.D. Ca. 2003)(requiring strict compliance with requirement of disclosing "connections," regardless of harshness of rule).

Such a result also befell the examiner in In re Big Rivers Elect. Corp., 355 F.3d 415 (6th Cir. 2004). There, the examiner (an experienced bankruptcy attorney), negotiated "side agreements" with three major creditors providing that he receive additional compensation as a percentage of additional recoveries. Although he did not disclose these agreements, he requested compensation including a percentage fee enhancement in addition to his hourly rate as specified in his application for employment. Ultimately, the enhancement was denied, the hourly rate fees requested were denied, and the examiner was required to disgorge all fees previously paid. The Court held that an examiner has three basic duties. First, he must be and remain "disinterested." Second, he must comply with the disclosure requirements of the Federal Rules of Bankruptcy Procedure. Third, examiners owe the creditors and shareholders a duty of loyalty. The court held that the examiner's conduct violated each of these duties[37].

[37] One fact that clearly did not help his cause was the examiner's denial that he had entered into any such side agreements. In response, objecting creditors submitted copies of his letters which clearly stated that such agreements existed. His somewhat creative, but ultimately unconvincing reply, was that the letters contained intentional misstatements, arguing to the court that: "A common tactic used in negotiations is to make a statement, as if it were a fact, even though the statement is incorrect and is known to be incorrect." Id. at 427. The Sixth Circuit did not seem to favor either the proposition that Mr. Schilling lied to the Court, or even his defense that he was only lying to the creditors.

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II. Increased "Policing" Obligations for Professionals

A. Under Sarbanes-Oxley

While a detailed discussion of the provisions of the Sarbanes-Oxley Act of 2002 is beyond the scope of these materials,[38] it should be noted that this legislation creates, in certain circumstances, obligations of counsel to take affirmative steps upon discovery of evidence[39] of a material violation of state or federal securities laws, breach of fiduciary duties, or similar acts by a company or any agent thereof. Initially, such violations must be reported to the chief legal officer or chief executive officer. In the absence of an appropriate response, report must be made to the board of directors or certain board committees. While the original draft regulations required an attorney who is discharged on account of such reporting to notify the SEC, the final regulations require such reporting by the company. The Act applies to attorneys who practice before the SEC (which can include such innocuous acts as communications) and to clients who are "issuers" of registered securities[40].

From a theoretical standpoint, the attorney's obligation to report to the client (the corporate entity) when the attorney believes that improper acts are being conducted by individual officers, directors, employers, or "other agents" does not seem unusually disturbing in and of itself. However, the Act places the attorney in a more active role, of monitoring conduct of the client and its agents, as well as demanding and ensuring that the client provide an appropriate response[41] to counsel. This is a somewhat unusual mandate. The further possibility that counsel may incur independent liability[42] for breach of the Act (as opposed to counsel's general accountability to his or her client) is apt to place counsel in the untenable position of attempting to balance the instructions of the client (and possibly the interests of the client) against the individual interests of the attorney.

One aspect of the regulations which should not sound unfamiliar to bankruptcy practitioners is found in 17 CFR 205.3 (a), which provides:

> *Representing an Issuer.* An attorney appearing and practicing before the Commission in the representation of an issue owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors, ore

[38] For such a discussion, see Prof. Robert M. Lawless, *Some Thoughts for Bankruptcy Practitioners on Sarbanes-Oxley, Related Regulatory Developments, and the New Listing Standards,* ABI Southwest Bankruptcy Conference 2003 (available to ABI members on the ABI website www.abiworld.org).

[39] See 17 CFR 205.2(e) for definition of "Evidence of a material violation."

[40] See 17 CFR 205.2(h).

[41] See 17 CFR 205.2 for the definition of an "appropriate response."

[42] A violation by an attorney "shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the Commission in an action brought by the Commission thereunder." 17 CFR 205.6(a), in addition to possible disciplinary proceedings by the Commission.

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employees in the course of representing the issuer does not make such individuals the attorney's clients.

As discussed below, this fundamental tenant is very helpful in analyzing the duties of professionals in the bankruptcy arena.

B. Increased "Recognition" of Duties Owed to Non-Clients

There is a growing body of authority and commentary[43] regarding the obligation of debtor's counsel to police acts taken by the debtor or its management during bankruptcy proceedings. Debtor's counsel has a difficult enough burden without being a policeman for the debtor's postpetition conduct. The Bankruptcy Code leaves that role to creditors' committees, individual creditors, and the United States Trustee. Vehicles are available to organized constituencies and individual parties in interest (as well as the United States Trustee) in the form of the appointment of a trustee or conversion of the case, such that counsel and management should be free to exercise a reasonable degree of flexibility with the estate's assets to achieve a successful reorganization. However, several courts have held that attorneys have a broader duty, sometimes characterized as a "fiduciary duty", to various constituencies in a chapter 11 case.

At one end of the spectrum, it may be argued that counsel for the debtor-in-possession should have no greater duty than to give appropriate legal advice to members of management. After all, lawyers are not retained to provide business advice to clients. Model Rule 1.2 clearly provides that a lawyer shall abide by a client's decision concerning the objectives of the representation. Model Rule 1.4(b) provides that the lawyer must explain to the client the alternatives available, but that the client ultimately decides the course of action to be taken. The lawyer represents the organization which itself acts through its duly authorized constituents. Several courts have recognized that under applicable ethical rules, counsel for a debtor entity is directed by management.[44] Ethically and legally, counsel to the debtor in possession can only advise the debtor's designated representatives who make the decisions.

Further, the debtor in possession and its management are not required by the Bankruptcy Code to be disinterested.[45] To the contrary, Congress contemplated that the competing interests of creditors could be protected by their own counsel, by creditors' committees and by the United States Trustee. Attorneys who take directions from interested insider management are not substitutes for the trustees, and Congress seemingly intended not to impose upon debtor's

[43] See, e.g., Bruce A. Markell, *The Folly of Representing Insolvent Corporations: Examining Lawyer Liability and Ethical Issues Involved in Extending Fiduciary Duties to Creditors*, 6 J. Bankr. L. & Prac. 403 (1997); Rappoport & Bowles, *Has the DIP's Attorney Become the Ultimate Creditors' Lawyer in Bankruptcy Reorganization Cases?*, 5 Am. Bankr. Inst. L. Rev. 47 (1997).

[44] See In re Nephi Rubber Prods. Corp., 120 B.R. 477, 482 (Bankr. N.D. Ind. 1990) (stating officers and directors choose counsel and counsel obligated to follow directors); see also In re Hurst Lincoln Mercury, Inc., 80 B.R. 894, 897 (Bankr. S.D. Ohio 1987) (stating counsel must look to operating head of DIP as client's voice).

[45] See, e.g., In re Best Western Heritage Inn Partnership, 79 B.R. 736, 740 (Bankr. E.D. Tenn. 1987) (stating no reason for debtor in possession to be disinterested).

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counsel, through the vehicle of disinterestedness, a duty to insure that insider management act as a trustee. For example, in In re Best Western Heritage Inn Partnership,[46] the court observed that it is difficult to believe that Congress intended to require a disinterested attorney for the debtor in possession to safeguard the rights of creditors and investors. Vigorous advocacy by debtor's counsel is not only ethical; it is required.

Thus, some courts explicitly find that counsel for the "debtor-in-possession" does not have "fiduciary obligations" to creditors or other non-client entities. See, e.g., In re Sidco, Inc., 173 B.R. 194 (E.D. Cal. 1994)("attorneys for debtors-in-possession have a fiduciary duty to their client, the debtor-in-possession, not to the creditors and shareholders whose interests may be adverse to the debtor."); ICM Notes v. Andrews & Kurth, LLP, 278 B.R. 117 (S.D. Tex. 2002), aff'd per curiam, 324 F.3d 768 (5th Cir. 2003)(while a debtor in possession has general fiduciary duties to preserve the bankruptcy estate and advise the debtor in possession, the attorney for the debtor in possession does not have fiduciary duties to an individual creditor).

Some courts have held that counsel for the debtor in possession has a duty to inquire when warning flags appear regarding actions by the debtor or the debtor's principal and to counsel the client in an effort to resolve those concerns. For example, in In re Perez, 30 F.3d 1209, 1219 (9th Cir. 1994), the court held that when debtor's counsel has "material doubts" about whether a course of action proposed by the debtor-in-possession serves the best interest of the estate, the lawyer seek to persuade the client to take a different course of action. See also, e.g., In re Consupak, Inc., 87 B.R. 529, 548-49 (Bankr. N.D. Ill. 1988) (stating that duty of trustee's attorney requires active concern for interests of estate and unsecured creditors, including taking initiative "to inform his client of the need for preventative or corrective action."). This "watchdog" function may seem less uncomfortable by reference to the distinction between the client as a corporate entity and the individuals charged with responsibility to manage it. Where counsel believes that individual members of management are undertaking a course of action which is violative of the client's responsibilities, it is logical to impose upon counsel the duty to advise against such a course of action, as a natural act in discharge of counsel's responsibility to the corporate entity. Judges seem to agree that a lawyer should counsel its clients as to the need to property discharge their fiduciary duties.[47] However, at least some courts have recognized that counsel should thereafter abide by the client's decision so long as there is a non-frivolous basis for doing so.[48] However, this is a far cry from imposing upon debtor's counsel "fiduciary duties" to non-client entities, such as creditors. As stated in Perez:

> Counsel for the estate must keep firmly in mind that his client is the estate and not the debtor individually. Counsel has an independent responsibility to determine whether a proposed course of action is likely to benefit the estate or will merely cause delay or produce some other procedural advantage to the debtor. While he must always take his directions from his client, where counsel for the estate develops material

[46] Id.

[47] See In re TS Indus., Inc., 125 B.R. 638, 642 (Bankr. D. Utah 1991); In re NRG Resources, Inc., 64 B.R. 643, 647 (W.D. La. 1986).

[48] See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2 (providing lawyer must abide by client's decision as long as decision ethically permissible).

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> doubts about whether a proposed course of action in fact serves the estate's interest, he must seek to persuade his client to take a different course or, failing that, resign. Under no circumstances, however, may the lawyer for a bankruptcy estate pursue a course of action, unless he has determined in good faith and as an exercise of his professional judgment that the course complies with the Bankruptcy Code and serves the best interest of the estate.

30 F.3d at 1219.

Perhaps unfortunately, courts have sometimes indicated that counsel for the debtor-in-possession owes a "fiduciary duty" to the estate or its creditors. See In re Wilde Horse Enterprises., Inc., 136 B.R. 830, 840 (Bankr. C.D. Cal. 1991) (stating attorney is fiduciary to estate and has duty to remind debtor of duties under Code); In re Sky Valley, Inc., 135 B.R. 925, 939 (Bankr. N.D. Ga. 1992) ("[b]ecause counsel for debtor in possession has [a] fiduciary duty, counsel may be placed in the 'unusual position of sometimes owing a higher duty to the estate and the bankruptcy court than to his client.'"); In re Blue Top Family Restaurant, Inc., 110 B.R. 777, 778 (Bankr. W.D. Pa. 1990) ("Counsel filing cases in this court on behalf of debtors, in order to obtain the relief and protection accorded by the Bankruptcy Code, stand in a fiduciary relation to their clients, the prepetition creditors and the postpetition creditors; inflicting further damage on those parties is a violation of that fiduciary duty."); Consupak, 87 B.R. at 548; In re Imperial "400" Nat'l, Inc., 456 F.2d 926, 929 (3d Cir.1972) ("A trustee in reorganization is an officer of the court who occupies a special fiduciary position, and counsel for the trustee has equivalent fiduciary responsibilities to the estate in reorganization and to the creditors."); In re Whitney Place Partners, 147 B.R. at 620-21 ("[T]he status of the client and the attorney may often overlap in a Chapter 11 case, as the debtor's attorney must take conceptual control of the case and provide guidance for management of the debtor, not only to discern what measures are necessary to achieve a successful reorganization, but to assure that, in so doing, compliance with the Bankruptcy Code and Rules is sought rather than avoided."); In re Harp, 166 B.R. 740, 748 (Bankr. N.D. Ala. 1993) (same)[49].

Counsel should also be aware of cases such as In re Rivers,[50] which stated that an attorney has the duty to advise the U.S. Trustee and the court if a debtor in possession is incompetent, making a reorganization unlikely. The court observed that the attorney's duty to the court and duty as fiduciary to the bankruptcy estate deserves higher allegiance than the role as attorney for the debtor.

At first glance, such a position may seem logical. After all, the attorney for the debtor-in-possession clearly has a fiduciary duty to his client. Further, the debtor-in-possession owes fiduciary duties to the estate and its creditors.[51] It is perhaps unsurprising, then, that some

[49] For an extensive discussion of the issue of this issue, see Hansen, Jones & Leta, P.C. v. Segal, 220 B.R. 434 (D.C.Utah 1998).

[50] 167 B.R. 288 (Bankr. N.D. Ga. 1994).

[51] See United States v. Aldrich (In re Rigden), 795 F.2d 727, 730 (9th Cir. 1986) (stating chapter 11 trustee or debtor in possession has "fiduciary obligation to conserve the assets of the estate and to maximize distribution to creditors"); First Union Nat'l Bank v. Tenn-Fla Partners (In re Tenn-Fla

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courts conclude that the attorney for the debtor-in-possession owes fiduciary duties to the estate and its creditors. However, such a rule would put counsel in an impossible position. Counsel for the debtor-in-possession must be disinterested. Fundamental to this concept is that the attorney may not hold or represent the holder of a claim or equity interest in the case. To impose a "fiduciary duty" to those same constituents would destroy the principle and requirement of disinterestedness. Further, as noted above, such a holding blurs, if not erases, the line between the client (who makes "business decisions") and the lawyer (who advises, but does not control, the client). "Even though a lawyer represents a bankruptcy entity subject to the control of the bankruptcy court, fundamentally, the lawyer is still an advocate for decisions made by the debtor-in-possession-the lawyer's client. A lawyer must accept decisions made by a debtor-in-possession even if their utility or prudence is doubtful." In re Spanjer Bros., 191 B.R. 738, 751-52 (Bankr. N.D. Ill. 1996). If the attorney owes independent fiduciary duties to creditors, to the estate (arguably including the interests of equity holders) or to some other amorphous entity, the attorney is placed in the uncomfortable position of having a duty to second guess the business judgment of individuals who control the debtor-in-possession and the impossible position of having a personal pecuniary interest in the client's internal governance.

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Thus, the more reasoned view is that the attorney owes fiduciary duties only to his client; however, the attorney for the debtor-in-possession should counsel management when actions taken or proposed appear to deviate from the client's fiduciary duties to the estate and its creditors. In addition, the attorney has a duty to refrain from filing bad faith or frivolous pleadings and to withdraw if the high standard for withdrawal is met.[52] In the bankruptcy context, an attorney may also face a penalty if the actions taken, even at management's direction, are not reasonably calculated to benefit the estate. In such a case, fees may be reduced or denied. See, e.g., Hansen, Jones & Leta P.C. v. Segal, 220 B.R. 434 (D.C. Utah 1998):

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> The "fiduciary duty to the estate" language interspersed throughout the above-cited opinions is no doubt intended to impress on counsel for debtor-in-possession his/her obligation to assist the debtor-in-possession in carrying out its responsibility to act in the best interest of the estate. However, the confusion wrought by this undefined duty and its intended oblige outweighs its utility. The strict prohibition of conflict of interest and overreaching by counsel and the disclosure requirements under the bankruptcy code layered over counsel's ethical responsibilities to the fiduciary client debtor-in-possession generally mandate this result. The ultimate assurance, though, lies in the bankruptcy court's assessment of counsel's compensation under 11 U.S.C. §330.

Id. at 465.

Partners), 170 B.R. 946, 970 (Bankr. W.D. Tenn. 1994) (same); National Convenience Stores Inc., v. Shields, 106 B.R. 792, 797 (Bankr. S.D. Tex. 1993) (recognizing debtor in possession's management takes on heightened fiduciary duties of chapter 11 trustee).

[52] See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.16(a), (b).

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C. Recognition of Liability for "Deepening Insolvency" Theory

One litigation trend is the increasing recognition of "deepening insolvency" causes of action[53]. While officers and directors may be responsible for permitting a debtor to continue to operate, incurring additional debt, during a period of insolvency, such a cause of action may also be brought against professionals. See, e.g., Allard v. Arthur Andersen & Co. (USA), 924 F.Supp. 488, 494 (denying auditor's summary judgment motion on grounds that it could not be held responsible for lost profits incurred during a period of deepening insolvency, as well as recognizing that firm could be liable for failure to discover misappropriation of funds); In re Computer Personalities Systems, Inc., 2003 WL 22844863 (Bankr. E.D. Pa. 2003)(claim against accounting firm); In re Flagship Healthcare, Inc., 269 B.R. 721 (Bankr. S.D. Fla. 2001)(claim against financial advisors); In re RDM Sports Group, Inc., 277 B.R. 415 (Bankr N.D. Ga. 2002)(claim against attorneys).[54]

III. Requests for Indemnification in Favor of Retained Professionals?

Recently, the issue of debtors indemnifying their professionals has come to the forefront. The Third Circuit addressed the issue in In re United Artist Theatre Co. v. Walton, 315 F.3d 217 (3rd Cir. 2003). It rejected the U.S. Trustee's argument that professional indemnification is prohibited by the reasonableness standard of 11 U.S.C. § 328(a) because that section does not prohibit indemnification, the agreements are becoming more common in the general marketplace and the reasonableness test is best reviewed on a case-by-case basis. Indemnity provisions that would indemnify a professional for gross negligence were not reasonable.

However, not all such provisions will pass muster. Engagement letter provisions for a financial advisor that included forum selection and provisions that the work could not be relied upon by anyone for any purpose were rejected in In re Komag, Inc., 268 B.R. 566 (Bankr. N.D. Ca. 2001).

IV. Consequences of Ethical Violations

As noted throughout this article and in other sources, it appears that in the majority of cases where violations occur, attorneys are economically penalized by courts refusing to approve fee applications for work done. However, more extreme penalties are available in appropriate circumstances.

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[53] See, e.g., Schacht v. Brown, 711 F.2d 1343 (7th Cir.), cert denied, 464 U.S. 1002 (1983); Hannover Corp. of America v. Beckner, 211 B.R. 849 (M.D. La. 1997); Allard v. Arthur Andersen & Co. (USA), 924 F.Supp. 488; In re Gouiran Holdings, Inc., 165 B.R. 104 (E.D.N.Y. 1994); In re Investor's Funding Corp. of New York Secs. Litig., 523 F.Supp 533 (S.D.N.Y. 1980); In re Walnut Leasing Co., 1999 WL 729267 (E.D. Pa. Sept. 8, 1999). But see Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, (3rd Cir. 2001)(recognizing tort of deepening insolvency and standing of creditors' committee to bring action on behalf of corporate debtor against its principals, but finding that debtor corporation was *in pari delicto* with defendant and that action should therefore be dismissed.

[54] In In re Exide Technologies, Inc., 299 B.R. 732 (Bankr. D. Del. 2003), this theory was extended to debtor's prepetition lenders based upon their significant control of the debtor prepetition.

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A. Fines and Imprisonment

Some violations may be criminal and carry penalties of fines and possible imprisonment. Although such cases are thankfully uncommon, attorneys should nevertheless should be aware of these cases so as to avoid even being implicated. For instance, under title 18 section 156, non-lawyer bankruptcy petition preparers[55] are now subjected to federal criminal liability. In fact, the FBI has begun investigating more bankruptcy crimes than at any other time in the past. The section was revised partly a result of the notoriety of the problem. The Bankruptcy Reform Act of 1994 not only revised and clarified the existing provisions of title 18 sections 152, 153, and 154, it added two new sections, section 156 and section 157. Section 157 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; (2) files a document in a proceeding under title 11; or (3) makes a false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under title 11, . . . shall be fined under this title, imprisoned not more than 5 years, or both.[56]

While the primary emphasis is on non-lawyers, attorneys should be aware of sanctions they might be subjected to for authorizing the filing of a debtor's fraudulent petition.[57]

B. Conspiracy Theory

Attorneys may also be potentially exposed to liability under a conspiracy theory wherein the attorney is found liable as a co-conspirator for the tortious conduct of his client.[58] The Arizona Supreme Court has found that a judgment creditor can recover from the attorney whose debtor-client made a fraudulent transfer. In McElhanon, the attorney actively advised and assisted his client, a judgment debtor, and was in fact a transferee of some of the fraudulently transferred assets. The judgment creditor was successful in obtaining a judgment against the lawyer on a conspiracy to defraud theory.

C. Suspension or Disbarment

Although infrequently seen, disbarment or suspension is a possible result of continuing to represent a client engaged in a fraudulent scheme. For example, in Townsend v. State Bar of

[55] 18 U.S.C. § 156(a) (1994) defines a "bankruptcy petition preparer" as "a person, other than the debtor's attorney or an employee of such an attorney, who prepares for compensation a document for filing." Id.

[56] See 18 U.S.C. § 157.

[57] See, e.g., In re Hessinger & Assocs., 171 B.R. 366, 372 (Bankr. N.D. Cal. 1994) (sanctioning attorney for acting as figurehead for nonlawyers who charged legal fees); Geibank Indus. Bank v. Martin (In re Martin), 97 B.R. 1013, 1017 (Bankr. N.D. Ga. 1989) (sanctioning attorney for authorizing someone in his office to sign, prepare, and file debtor's petition).

[58] See McElhanon v. Hing, 728 P.2d 273, 278 (Ariz. 1986) (holding attorney liable for conspiracy with client)., cert. denied, 481 U.S. 1030 (1987).

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California,[59] an attorney received a three-year suspension for advising a client to convey property fraudulently.[60] Similarly, in Suffolk County Bar Ass'n v. Pfingst (In re Pfingst),[61] an attorney was disbarred for participation in fraudulent conveyances in contemplation of bankruptcy.[62] Even if an attorney lacks any prior disciplinary record, the court may find the violation so offensive so as to warrant disbarment.[63]

D. Sanctions

A $25,000 sanction against an incredibly rude attorney was affirmed by the Fifth Circuit in In re First City Bancorporation of Texas, Inc., 282 F.3d 864, 265 (5th Cir. 2002). The court summarized the basis for affirming the lower court's decision as follows:

> His attitude and remarks toward opposing attorneys, opposing parties, and the bankruptcy court were--to understate his conduct--obnoxious. Although incivility in and of itself is call for concern, what is most disconcerting here is the rationale [the attorney] gives for his behavior. [The attorney] asserts that his deplorable and wholly unprofessional conduct helps him recover more money for his clients. Unremorsefully and brazenly, [the attorney] contends that his egregious behavior serves him well in settlement negotiations and is therefore appropriate.

V. Protection in Final Fee Applications

The emphasis on final fee applications was heightened by the determination that the ruling effectively precluded the debtor from thereafter alleging professional malpractice claims against the professional for services provided during the case. In doing so, courts ruled that the final fee application process determined the nature and the value of the professionals' services. If the professionals had committed malpractice, that would have been reflected in a reduction in the award. Intelogic Trace Inc. v. Ernst & Young, LLP, 200 F.3d 382 (5th Cir. 2000). In this case, the debtor was aware of the potential claim when the final fee application was approved. It remains to be seen whether this will also apply to situations where the malpractice was discovered after the final fee application.

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[59] 197 P.2d 326 (Cal. 1948).

[60] 197 P.2d at 329.

[61] 385 N.Y.S.2d 806 (2d Dep't 1976).

[62] See id. at 807; see also Coppock v. State Bar of California, 749 P.2d 1317, 1330-31 (Cal. 1988) (giving attorney who allowed client to defraud others 90 day suspension, two years probation); Office of Disciplinary Counsel v. Stern, 526 A.2d 1180, 1186 (Pa. 1987) (disbarring attorney for allowing himself to be corrupted by client and corrupting labor leader), cert. denied, 488 U.S. 826 (1988).

[63] See People v. Schwartz, 814 P.2d 793, 794 (Colo. 1991) (finding despite lack of prior disciplinary record, federal convictions for conspiracy to commit bankruptcy fraud and other federal offenses warranted disbarment).

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V. Conclusion

Attorneys in all areas of law must practice within the bounds of ethical rules, whether they abide by the bare minimum required under state professional responsibility codes, state and federal statutes, or the dictates of their own conscience. However, in bankruptcy practice in particular, attorneys should carefully evaluate any proposed course of action, even before the decision is made to file a bankruptcy petition. Admittedly, the image of bankruptcy itself has changed for the better,[64] but the image of lawyers arguably has declined.[65] Being well informed concerning ethical rules would not only benefit the attorney by preventing any sanctions, but more importantly, uplift the trust of the client and the public in general.

[64] See John D. Ayer, *How to Think About Bankruptcy Ethics*, 60 AM. BANKR. L.J. 355, 365-66 (1986) (commenting that declaring bankruptcy no longer carries the stigma that it formerly did).

[65] See Nancy B. Rapoport, *Seeing the Forest and the Trees: The Proper Role of the Bankruptcy Attorney*, 70 IND. L.J. 783, 783 (1995) (noting abundance of lawyer jokes and cartoons which hint at public's disgust with a "profession that can unabashedly argue both sides of a question with equal vigor and can show absolutely no interest in considering, let alone resolving, important moral or social issues").

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