CONFLICT OF INTEREST AFTER THE 2005 LEGISLATION AND OTHER ETHICAL ISSUES

I. The 2005 Bankruptcy Bill Changes to the Ethical Landscape

A. Are You a Debt Relief Agency?: 11 U.S.C. §§ 101(3), (4A) (12A) 526-528

1. Definitions:

   a. Debt Relief Agency: 11 U.S.C. § 101(12A)

   b. Assisted Person: 11 U.S.C. § 101(3)

   c. Bankruptcy Assistance: 11 U.S.C. § 101(4A)

2. 11 U.S.C. § 526: Restrictions on Debt Relief Agencies

3. 11 U.S.C. § 527: Disclosures for Debt Relief Agencies

4. 11 U.S.C. § 528: Requirements for Debt Relief Agencies

   a. Important Note: Advertising - Remember the phrase "We are a debt relief agency. We help people file for bankruptcy relief under the Bankruptcy Code."

B. Bankruptcy Planning: The Identifying Marks of a Hog

1. Prior to the Bankruptcy Bill of 2005, numerous courts attempted to delineate what constitutes permissible bankruptcy planning. The best description of the numerous, often conflicting tests, is the simple "pig to hog" transformation analogy of In re Zouhar, 10 B.R. 154 (Bkrtcy. D. N.M. 1981) ("there is a principle of too much; phrased colloquially when a pig becomes a hog it is slaughtered.")

2. Cases Discussing Pre-Bankruptcy Planning:

   a. In re Bowyer, 916 F.2d 1056 (5th Cir. 1990) (Ruled denial of discharge was appropriate for conversion of less than $100,000 into homestead. Debtor's income was $240,000 but debtors claimed to live "modestly".) However, see In re Bowyer 932 F.2d 1100 (5th Cir. 1991) (On re-hearing circuit court reversed previous decision and upheld bankruptcy court ruling that debtor should receive discharge.)

b. In re Tamecki, 229 F.3d 205 (3rd Cir. 2000) (Discussing dismissal of Chapter 7 case because of exemption planning.)

c. Matter of Smiley, 864 F.2d 562 (7th Cir. 1989) (debtors purchase of $380,000 home and move to new jurisdiction results in loss of exemption and denial of discharge.

d. In re Carey, 938 F.2d 1073 (10th Cir. 1991) (Discussing denial of discharge from pre-bankruptcy planning.)

e. Norwest Bank v. Tveten, 848 F.2d 871 (8th Cir. 1988) (doctors are bad)

f. Hanson v. First National Bank, 848 F.2d 866 (farmers are good)

g. Matter of Reed, 700 F.2d 986 (5th Cir. 1983) (conversion of non-exempt assets of approximately $40,000 into homestead results in denial of discharge)

h. In re Johnson 80 B.R. 953 (Bkrtcy. D. Minn. 1987) (Doctors are good); aff'd, 101 B.R. 997 (D. Minn. 1988) (Ditto), remanded for further hearings, 880 F.2d 78 (8th Cir. 1989) (Don't know). on remand, In re Johnson, 124 B.R. 290 (Bkrtcy. D. Minn. 1991) (Whoops, doctors are bad after all.)

i. In re Covino, 187 B.R. 773 (Bkrtcy. S.D. Fla. 1995) (Discussing general test of what is permissible exemption planning.)

j. In re Harker, 181 B.R. 326 (Bkrtcy. E.D. Tenn. 1995) (Refusing to permit dismissal of case to allow exemption planning.)

k. In re Beckman, 104 B.R. 866 (Bkrtcy. S.D. Ohio 1989) (J. Guy Cole) (Discussing fraudulent conveyance issues related to exemption planning.)

3. Under the Bankruptcy Bill of 2005 Numerous Additional Restrictions Have Been Placed on Pre-Bankruptcy Planning

a. 11 U.S.C. §§ 522(b)(3) (o) and (p): Limitations on Claiming Homestead Exemptions

b. 11 U.S.C. § 523(a)(19): Non-Dischargeable Debts for Certain Security Law Violations: Sarbanes – Oxley expands again

c. 11 U.S.C. § 548(a)(1) and (e): Anti KERP Payments and Attack on Self Settled Trusts

C. Individual Debtors in Chapter 11: Has Toibb v. Radloff, 501 U.S. 157 (1991) Been Effectively Repealed?

1. 11 U.S.C. § 1115 The new property of the estate: post petition earnings

2. 11 U.S.C. §§ 1127 and 1141 Modification of an individual's Chapter 11 Plan post confirmation

3. 11 U.S.C. § 1129 Confirmation Requirements

D. New Fun and Games in Attempting to Convert Chapter 11 Cases to Chapter 7 or Appointing a Trustee:

1. 11 U.S.C. §§ 1104 and 1112

E. Committee Changes and the Committee Counsel's Information Duties: Mandating Waiver of the Attorney Client Privilege?

1. 11 U.S.C. § 1102

F. Chapter 7 Consumer Debt or Representation Conflicts: Investigation of Client.

1. 11 U.S.C. § 707(b)

G. Jurisdiction over Your Employment and Malpractice

1. 28 U.S.C. § 1334(e): Exclusive Jurisdiction over lawsuits involving 11 U.S.C. § 327 and related rule controversies.

II. Getting Started by Surprise: Ethical issues facing counsel for potential debtors facing involuntary bankruptcy petitions

Exhibit A

Bowles, Involuntary Fee Slaughter: The Perils of Professional Fees for Representing a Debtor During the GAP Period, 21 Am. Bankr. Inst. J. 24 (2002).

III. Who Do You Work For? Duty to clients in Chapter 11 Proceedings

Exhibit B

Rapoport and Bowles, Has the DIP's Counsel Become the Ultimate Creditors Lawyer in Bankruptcy Reorganization Cases?, 5 Am. Bank. Inst. L. Rev. 47 (1997).

Recent Ethical Issues

IV. Who is the Client: New Cases, New Problems

A. Service to Two Masters, Not a Good Idea: In re R&R Associates of Hampton, 402 F.3d 257 (1st Cir. 2005)

R&R Associates ("R&R") was a general partnership with two general partners, Choate and Gaudette. R&R's only asset was a single piece of commercial real estate.

In 1990, Gaudette retained a law firm ("Law Firm") to transfer $700,000 of his property to several family limited partnerships ("FIP"). The Law Firm later helped Choate transfer a significant amount of assets to other FIP's. Under applicable law, assets and interests in FIPs are extremely difficult to attach by creditors.

Later, in 1991, R&R was forced to filed a Chapter 11 proceeding. The Law Firm, in its application to be employed as R&R's chapter 11 counsel, failed to disclose their prior and ongoing representation of Gaudette and Choate.

During the course of the R&R chapter 11, the Law Firm stated to the Bankruptcy Court that Gaudette and Choate had sufficient assets to cover any shortfall in R&R's assets. Unfortunately, the Chapter 11 was a total failure and was converted to a Chapter 7. Further, Gaudette and Choate, due in part to their transfers to the FIP's, were in fact unable to cover the asset shortfall in the R&R estate.

The Chapter 7 Trustee requested the general partner's financial records and the Law Firm provided the Trustee with these records without disclosing the FLPs existence or the Law Firm's part in setting up the FLPs.

Ultimately, the Chapter 7 Trustee sued the Law Firm for negligent representation of R&R during the Chapter 11 and breach of their fiduciary duties and sought disgorgement of the Law Firm's $18,887.00 in legal fees paid by R&R to the Law Firm and $412,000.00 in other damages representing the unpaid claims in the case.

After two Bankruptcy Court opinions and two appeals to the U.S. District Court, (which ultimately affirmed the Bankruptcy Court's dismissal of the Trustee's lawsuit) the Trustee appealed the case to the First Circuit.

The First Circuit reversed the District Court decision finding:

1. The Law Firm had a duty of "care, candor and unswerving loyalty" to the Debtor;

2. The Law Firm breached these duties to R&R by:

    a. Making uninvestigated representations as to the general partners net worth;

    b. Assisting the general partners in shielding their assets from creditors;

    c. Failing to advise the Bankruptcy Court of their conflicts of interest

3. Entry of judgment was appropriate against the Law Firm in the amount of all unpaid claims of the R&R Estate ($412,000) was appropriate

Throughout the First Circuit's opinion, the Court notes that the Law Firm "affirmatively violated" its fiduciary duty to the Debtor by continuing post-petition to shield personal assets of the General Partners in the FLPs. Given the serious nature of the sanction this case should serve as a warning to all attorneys not to shield the assets of potential debtors of a chapter 11 debtor.

B. Bad Mushrooms, Man! In re Mushroom Transportation Company, Inc., 382 F.3d 325 (3rd Cir. 2004)

Third Circuit held that Debtor's law firm owes a fiduciary duty to a chapter 11 debtor in determining summary judgment motions related to a law firm and bank concerning an attorney's embezzlement of funds from a debtor.

C. Disclose, Disclose . . . In re Big Rivers Electric Corporation, 355 F.3d 415 (6th Cir. 2004)

A cautionary tale about why examiners and trustees should not attempt to obtain undisclosed agreements from creditors in the middle of a case concerning their compensation. Court found that the examiners undisclosed efforts to obtain a fee enhancement violated the examiner's duties of loyalty, disclosure and to remain disinterested and ordered disallowance and disgorgement of all fees even though Examiner brought to the estate an additional $145,000,000.00 to estate from his efforts.

D. A Case to Remember In re V&M Management, Inc., 321 F.3d 6 (1st Cir. 2003)

In V&M, the sole shareholder and former director of the debtor subchapter s corporation filed a state court lawsuit against chapter 11 debtor's law firm and bankruptcy trustee. Case was removed to Federal Court and was dismissed due to Bankruptcy Court's determination in the Chapter 11 case that there was no value to Debtor's equity interest.

E. And Again, Who is Your Client? Bergin v. Eerie World Entertainment, LLC, 2003 WL 22861948 (S.D.N.Y. Dec. 2, 2003)

Law firm disqualified as counsel for a chapter 11 debtor for (1) either representing the debtor's principal [or at least being severely confused as to who his client was]; (2) accepting payments of professional fees from the debtor's principal; and (3) ignoring causes of actions against associates of the principal.

F. Mutiney II: Mutineers Continue to Win. In re The Phoenix Group Corporation, 305 B.R. 447 (Bkrtcy N.D.Tx 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 the Debtors' counsel noted that the Debtors' principal was demanding that Debtors' counsel take actions and pursues strategies that Debtors' counsel found to be "legally and ethically improper. The second motion to withdraw was granted.

The Debtors' 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 ("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:

1. The Debtors could not get along with any attorney, as six of its 20 largest creditors were law firms;

2. The Debtors did in fact attempt to require their counsel take improper actions; and

3. 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.

G. Obey Your Master! In re Texasoil Enterprises, Inc., 296 B.R. 431 (Bkrtcy. N.D.Tx 2003)

Debtors' counsel ordered to disgorge $6,500 of $15,000.00 retainer for failing to have the Debtors comply with the Court's 11 U.S.C. § 1107 Order which limited the Debtors authority to operate post petition.

H. Make (and Disclose) Waivers: In re Jore Corporation, 298 B.R. 703 (Bkrtcy. D. Mont. 2003)

Chapter 11 debtor's law firm's fee application was denied and law firm was ordered to disgorge all fees and expenses previously paid (except for expenses relating to service of pleadings under case management order) due to Debtors' counsel's failure to fully disclose material limitations in a conflict waiver which Debtors' counsel had with the Debtors primary secured lender. The improper disclosure and conflicts of interest included conflicts with the secured lender on the details of professional fee carve outs for debtor's counsel.

I. Paint Your Wagoner as an Adverse Interest: In re Hampton Hotel Investors, L.P., 289 B.R. 563 (Bkrtcy S.D.N.Y. 2003)

After a chapter 11 case was converted to chapter 7, trustee brought suit against the chapter 11 Debtor's counsel ("Law Firm") for, among other things, assisting the Debtor's principals in violating the Debtor's fiduciary duties, including: (1) assisting the Debtor after the filing of its chapter 11 in retaining and compensating professionals without court order; (2) failing to recover assets of the estate; (3) assisting the Debtor in borrowing money, without court approval, to pay insiders; (4) paying pre-petition debts without court authorization; and (5) refusing to collect receivables from insiders.

The Law Firm moved to dismiss the complaint under the doctrine of Shearson Lehman Hutten, Inc. v. Wagoner, 944 F.2d 114 (2nd Cir. 1991) which greatly limits the ability of debtors to bring suits against parties that assisted the debtor's employees in harming the debtor under the doctrine of in pari delicto.

The Bankruptcy Court overruled the dismissal motion finding that the lawsuit against the Law Firm could proceed under the "Adverse Interest Exception" of Wagoner. The court further stated that the direct fiduciary duty the Law Firm had to the debtor's bankruptcy estate could also provide an exception to Wagoner.

J. A Single Screen: In re Angelika Films 57th, Inc., 227 B.R. 29 (Bkrtcy. S.D. N.Y. 1998).

In this case, the debtor's Chapter 11 counsel also represented the debtor's owner in numerous matters, including his divorce and a related replevin action with his former spouse and a major creditor of the debtor. The Chapter 11 attorneys were employed over the objection of the U.S. Trustee and the debtor's former spouse. During the Chapter 11 case, the debtor entered into an agreement to use its "good faith" efforts to market a valuable lease by a certain date, and if a motion to assume or assign the lease was not filed by that date, the debtor agreed to the appointment of a Trustee. After the debtor failed to get an extension of time to market the lease, the debtor's owner offered to "purchase" the lease for $100,000.00, 20% of its appraisal value of $500,000.00. The motion to assume had numerous other provisions favorable to the debtor's owner. The Bankruptcy Court rejected the motion to assume or assign the lease, finding it was filed in bad faith, and appointed a Chapter 11 Trustee. The District Court affirmed this decision.

Ultimately, the estate, through the Chapter 11 Trustee, was able to sell the lease for $1,000,000.00, ten times what the debtor's principal offered to purchase the lease for in the assumption and assignment motion. After the sale, the Chapter 11 counsel moved for approximately $491,000.00 in fees and ultimately entered into a settlement agreement for a reduced amount of fees with the other parties in the case. The Court, exercising its powers to review professional fees, denied all fees of the debtor's Chapter 11 counsel in this case, finding that the Chapter 11 counsel had abandoned its fiduciary duty to the debtor by its actions in this case. The Court specifically found that the attorneys had failed to fully inform the Court about the assumption motion and had represented primarily the debtor's owner's interests throughout the bankruptcy. This is an important case, because the Court even denied fees that were for services beneficial to the debtor.

K. Mutiny or Heroism? In re JLM, Inc., 210 B.R. 19 (BAP 2d Cir. 1997).

Counsel for the Chapter 11 debtor, JLM, Inc., was faced with an objection to its fees by the debtor's owner for their alleged refusal to obey the orders of the debtor's owners. The facts of this case are unusual, to say the least. At the commencement of the Chapter 11 case, the debtor was owned by two individuals who had also filed individual Chapter 11 petitions. The debtor's stock was pledged by the individuals to the primary secured lender of JLM. Through the individuals' Chapter 11 plans, the secured lender obtained direct ownership of all of the stock of JLM. In January of 1996, the secured creditors, some three months after JLM's bankruptcy and after the secured lender had discovered its security interest in JLM's personal property had lapsed, ordered the debtor's Chapter 11 counsel to dismiss the JLM Chapter 11 case, so it could perfect its lapsed security interest. The Chapter 11 counsel refused the direction and vigorously opposed the secured creditors'/owner's actions to dismiss the case or obtain stay relief to replace the debtor's management. Ultimately, the Bankruptcy Court ruled the secured creditors had the authority to operate the debtor, but found its actions in attempting to dismiss the Chapter 11 violated its fiduciary duty to all the estate creditors and appointed a Trustee. When debtor's counsel filed its final fee application, despite almost universal support, the Bankruptcy Court denied counsel's fees, ruling the Chapter 11 counsel was not entitled to any fees, as it represented the individuals who previously owned the debtor in opposing the secured creditors' actions and not JLM. The BAP reversed, finding that JLM's Chapter 11 counsel had apparently acted properly in opposing the actions of the secured creditor/owner, and remanded for a determination of whether the counsel's actions benefited the estate.

L. The Bad, the Sequel: Hansen, Jones & Leta, PC v. Segal, 220 B.R. 434 (D. Utah 1998).

In the main article, Dean Rapoport and I discussed the case of In re Bonneville Pacific Corporation, 196 B.R. 868 (Bkrtcy. D. Utah 1996) ("Bonnieville"). Approximately a year after our article was published, the District Court, accepting most of the same facts as set forth in Bonnieville, reversed the denial of fees under an abuse of discretion standard.

The principal grounds for the District Court's reversal of the Bonnieville decision were its explicit determination that Chapter 11 debtor's counsel does not owe a fiduciary duty to a Chapter 11 bankruptcy estate and its implicit determination that the debtor's counsel was not as responsible for the debtor's misconduct, as the Bankruptcy Court had found debtor's counsel to be in its opinion.

On the legal issue, the Hansen court determined that a Chapter 11 debtor's counsel's client is not the bankruptcy estate, because no such entity exists. The Hansen court reviewed in detail the massive amount of case law and scholarly works on whether the bankruptcy estate exists and, based on the U.S. Supreme Court's decision in National Labor Relations Board v. Bildisco & Bildisco, 465 U.S. (1984), held that no entity known as the "bankruptcy estate" was created when a Chapter 11 was filed and that therefore a Chapter 11 debtor's counsel must owe its duties to the debtor-in-possession.

Based on this decision, the Hansen court ruled that the Chapter 11 debtor's counsel had fulfilled its duties to its clients, the debtor-in-possession. The Hansen court rejected the massive amount of case law which imposes fiduciary duties on counsel for the debtor-in-possession as "unhelpful and unnecessary to insure the counsel is independent and aware of his/her duty under the Bankruptcy Code and Model rules to represent and assist the debtor-in-possession in the performance of its duties." 220 B.R. at 460.

The Hansen case's legal reasoning produces some unintended problems, as it indicates that counsel for the estate may have some duty to the people who make up the debtor-in-possession, as opposed to the bankruptcy estate. This may give some unscrupulous debtors-in-possession the leverage they need to force Chapter 11 counsel to be their "willing" dupes in their actions to defraud debtors or harm the bankruptcy estate.

The Hansen court's decision may be more explainable on its implicit factual reasoning. The District Court did not overrule the factual findings of the Bankruptcy Court, but made additional and more detailed findings which cost counsel for the DIP in a far more sympathetic light than did the Bankruptcy Court. As an example, the District Court, in footnote 57 to its opinion, emphasized the fact that the debtor's Chapter 11 counsel was not guilty of assisting in the debtor's fraud.

In summary, the Hansen decision provides at least a well-reasoned decision which questions the validity of the theoretical underpinning of the majority line of attorney fiduciary duty cases. However, the authors of the attached article disagree with the Hansen court's decision and still believe that except for the ruling on the unsecured creditors committee's fees, Bonnieville is the more persuasive opinion.

V. The Sum of our Damages

A number of recent cases have addressed issues related to lawsuits against Chapter 11 debtors' counsel for breaches of their fiduciary duty. Under amended 28 U.S.C. § 1334(e) nearly all of these cases will have to be heard in Federal Court as the Federal Court has exclusive jurisdiction over all claims involving 11 U.S.C. § 327 and rules related thereto.

A. Kittay v. Kornstein, 230 F.3d 531 (2nd Cir. 2000). (Court permitted breach of fiduciary duty suit to go forward on complaint that special counsel to the debtor harmed debtor's bankruptcy estate by actions related to simultaneous representation of creditor claiming estate

assets. Court also held that representing multiple adverse clients is not a cause of action in and of itself.)

B. First Interstate Bank of Az v. Murphy, Weir & Butler, 210 F. 983 (9th Cir. 2000). (Law firm was sued because it hired a judge's law clerk and the clerk continued to work on its future employer cases in violation of several portions of the Code of Judicial Conduct and Code of Conduct for Law Clerks. After discovery of this problem, the judge recluse himself from the case and the new judge ordered a new trial, after which the hiring law firm's client received a less favorable ruling. The Ninth Circuit held that it was the judge's and law clerk's duty to take proper ethical action, and that law firm had no independent duty to disclose or take steps to ensure judicial Codes of Conduct are followed. Good case to read if you are hiring a judge's law clerk.)

C. In re Verit Industries, Inc., 172 F.3d 61 (9th Cir. 1999) (unpublished decision available on WestLaw). (Discussing whether settlement agreement released debtor's pre-petition attorney from actions for legal malpractice and breach of fiduciary duty cases of action).

D. ICM Notes, Ltd. v. Andrews & Kurth, LLP, 278 B.R. 117 (S.D. TX. 2002), aff'd w/o opinion, 324 F.3d 768 (5th Cir. 2003). (Recent case which reaffirms the doctrine that Chapter 11 professionals do not owe a fiduciary duty to specific creditors. Court dismissed claim against debtor's counsel for breach of fiduciary duty by creditor which was attempting to acquire the debtor through a plan of reorganization.)

E. Matter of RDM Sports Group, Inc., 260 B.R. 915 (Bkrtcy. N.D. GA. 2001). (Chapter 11 Trustee has right to jury trial in Bankruptcy Court on suit against debtor's professionals for breach of fiduciary duty).

F. In re C Power Products, 230 B.R. 800 (Bkrtcy. N.D. TX. 1998). (Discussing issues related to standing to bring legal malpractice and breach of fiduciary duty claims).

G. Borden v. Clement, 261 B.R. 275 (Bkrtcy. N.D. Ala. 2001). (Dismissal of lawsuit against Chapter 11 debtor's counsel by owner of Chapter 11 debtor, alleging that attorney breached fiduciary duties to owner and was guilty of malpractice. Important discussion on how to withdraw from case.)

VI. Bankruptcy Ethics Cases Are Like a Box of Chocolates: You Never Know What You Might Find

A. In re Bame, 251 B.R. 367 (Bkrtcy. D. Minn. 2000). (Discussing Fifth Amendment privilege as it relates to documents produced to an individual debtor's Chapter 11 counsel).

B. In re Mushroom Transportation Company, Inc., 247 B.R. 395 (E.D. Pa. 2000). (In an interesting twist, discussing whether a Chapter 11 debtor-in-possession could be liable for breach of fiduciary duty by debtor's counsel).

C. In re Vebeliunas, 231 B.R. 181 (Bkrtcy. S.D. N.Y. 1999). (Unusual case disqualifying counsel for Trustee, where Trustee's counsel thought the debtor was a crook).

D. In re Entertainment, Inc., 225 B.R. 412 (Bkrtcy. N.D. Ill. 1998). (Case which discusses why it is a bad idea to file a bankruptcy where the owners of the debtor are at war).

3. Getting Out with Your "Professional Life": Options if the People Running Your Client Go Bad

Exhibit C

Bowles, Noisy Withdrawals: Urban Bankruptcy Legend or Invaluable Ethical Tool?, 20 Am. Bankr. Inst. J. 26 (2001).