PROFESSIONAL LIABILITY: LANDMINES AND TRIPWIRES

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I. Professional Responsibility in Bankruptcy Cases

A. The Multi-Layered Professional Responsibility of Attorneys for Debtors in Possession

Counsel to an entity in the zone of insolvency, a debtor in possession ("DIP") or a trustee all owe significant fiduciary duties to their clients, as defined and described by the courts, the Bankruptcy Code, the Model Rules of Professional Responsibility, and applicable state law. In addition, courts have imposed upon counsel to such clients fiduciary duties parallel to the clients'. Thus a tension exists as between (a) the fundamental ethical obligations imposed on the lawyer by state law, and (b) the complex overlay of trust-derived fiduciary obligations that may be imputed to the attorney. Determining the parameters of these attributed client-derived fiduciary duties is essential, yet the case law varies considerably.

1. The Fiduciary Duty of a Corporate Entity in the Zone of Insolvency

Directors and officers of a solvent entity have fiduciary duties to protect the interests of the shareholders of the entity. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). The fiduciary duty includes the duty of loyalty, the duty of care, the duty of good faith and the duty of candor (which some contend are subsumed in the duties of loyalty or good faith). Skeen v. JoAnn Stores, Inc., 750 A.2d 1170 (Del. 2000); Gully v. National Credit Union Admin. Bd., 341 F.3d 155 (2d Cir. 2003) (duties include good faith, conscientious fairness, morality and honesty in purpose, and displaying good and prudent management).

Officers and Directors of an entity in the vicinity of insolvency, however, also owe a fiduciary duty to creditors. Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corporation, 1991 WL 277613, n. 55 (Del. Ch.) ("[I]n managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right…course to follow for the corporation may diverge from the choice that the stockholders…would make if given the opportunity to act"); Xonics Med. Sys. v. Haverty, 99 B.R. 870, 872 (Bankr. N.D. Ill. 1989) (stating that a fiduciary duty to creditors begins when a corporation becomes insolvent).

2. The Fiduciary Duty of a Debtor in Possession

The fiduciary duty of the DIP and its managers is often analogized to the duty that officers and directors of a corporation owe their shareholders outside of bankruptcy. In re

Bellevue Place Assocs., 171 B.R. 615, 623 (Bankr. N.D. Ill.1994) citing In re Schipper, 933 F.3d 513 (7th Cir. 1991). It is also compared to the duties owed by a trustee under the common law. C.R. Bowles, Jr. & Nancy B. Rapoport, Has the DIP's Attorney become the Ultimate Creditors' Lawyer in Bankruptcy Reorganization Cases?, 5 Am.Bankr.Inst.L.Rev. 47 (1997) citing In re Frankel, 77 B.R. 401, 404 (Bankr. W.D.N.Y. 1987). However, the fiduciary duty of the DIP and especially DIP counsel is not only determined from the common law, but also from the Bankruptcy Code and the Model Rules.

Under the Model Rules of Professional Responsibility (the "Model Rules"), counsel represents an entity through its duly authorized constituents. Model Rule 1.13. However, when that entity becomes insolvent or is on the verge of insolvency, counsel must recognize the shifting fiduciary duty of the entity and advise its client accordingly. Indeed, as the law currently stands, upon the filing by the client of a Chapter 11 petition, counsel's duty to its client suddenly is expanded to parallel the duty owed by the entity itself.

a. The Bankruptcy Code and Model Rules

The Bankruptcy Code and Model Rules should be the starting point for any discussion of duties. The following Bankruptcy Code provisions and Model Rules provide the essential groundwork for defining the fiduciary duty of DIP counsel.

i. Bankruptcy Code

- **11 U.S.C. § 1107 – Rights, powers and duties of debtor in possession**

> (a) Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in section 1106(a)(2),(3), and (4) of this title, of a trustee serving in a case under this chapter. 11 U.S.C. § 1107(a).

- **11 U.S.C. § 323 – Role and capacity of trustee**

> (a) The trustee in a case under this title is the representative of the estate.

These provisions vest the DIP with the powers and duties of a trustee. A trustee is an officer of the court and is held to high fiduciary standards of conduct. Matter of Topco, Inc., 894 F.2d 727 (C.A.5 (Tex.) 1990) rehearing denied, 902 F.2d 955; In re Quakertown Shopping Center, Inc., 248 F.Supp. 749 (E.D.Pa. 1965) reversed and remanded on other grounds, 366 F.2d 95 (stating that a trustee of bankrupt's estate is agent of bankruptcy court). Additionally, a trustee is a statutory fiduciary to the bankrupt estate and its beneficiaries (which include its creditors and equity security holders). In re WHET, Inc., 750 F.2d 149 (1st Cir. 1984) (stating that a trustee is a representative of the estate and owes a fiduciary duty to debtor and creditors alike to act fairly and protect their interests and in such regard the trustee

may from time to time hire attorneys to represent him). Thus, under section 1107, the DIP has the same fiduciary duty to the court and to the estate as does the trustee. 11 U.S.C. §§ 323, 1107.

- **11 U.S.C. § 327 – Employment of professional persons**

> (a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys…or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

- **11 U.S.C. § 328 – Limitation on compensation of professional persons**

> (b) Except as provided in section 327(a), 327(e), or 1107(b) of this title, the court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under section 327 or 1103 of this title if, at any time during such professional person's employment under section 327 or 1103 of this title, such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed.

These provisions provide that the trustee or DIP can employ counsel, provided that the attorneys are disinterested and do not hold an adverse interest to the estate. While these statutory provisions specifically impose a fiduciary duty on a DIP (sections 323 and 1107), no corresponding provisions exist in the Bankruptcy Code for attorneys representing the DIP. However, these provisions are widely used as a basis for arguing that DIP counsel owes an equivalent or parallel fiduciary duty to the estate and its beneficiaries.

B. Model Rules

- **Model Rule 1.1 - Competence** - A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation.

- **Model Rule 1.3 - Diligence** - A lawyer shall act with reasonable diligence and promptness in representing a client.

- **Model Rule 1.6 - Confidentiality of Information**

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

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

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

(2) to 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;

(3) to 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;

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

(5) 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

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

- **Rule 1.7 - Conflict of Interest: Current Clients**

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

> (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
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> (2) the representation is not prohibited by law;
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> (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
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> (4) each affected client gives informed consent, confirmed in writing.

These Rules present the most obvious points of tension for attorneys representing the DIP. As discussed above, while Rule 1.13 makes it clear that, pre-bankruptcy, counsel's only duty is to the organization acting through its duly authorized constituents, many cases hold that once the corporation is a DIP, DIP counsel has the same fiduciary duty to the estate and its beneficiaries as does the DIP itself. Rule 1.7 is seemingly at odds with such a characterization, as it precludes an attorney from representing any interests other than those of its "client." However, the question remains: Who is the client, the DIP or the estate? The Comment to Rule 1.7 contemplates this confusion in describing possible conflicts of interest in estate administration in general: "In estate administration, the identity of the client may be unclear under the law of a particular jurisdiction. Under one view, the client is the fiduciary; under another view, the client is the estate or trust, including its beneficiaries." "Estate" is defined in Section 541 of the Bankruptcy Code as "all legal and equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541.

b. The Common Law Split – Fiduciary to the DIP or the Estate?

The second level of authority defining the DIP counsel's fiduciary duty is the case law. The cases describing and defining the DIP counsel's fiduciary duties usually do so in the context of determining fee applications and compensation for DIP counsel. While it is undisputed that DIP counsel owes a fiduciary duty to the DIP and the Court, as will be discussed below, courts are split as to whether or not DIP counsel owes fiduciary duties to the bankruptcy estate. The following cases support the proposition that DIP counsel has a fiduciary duty to the estate:

- In re JLM, Inc., 210 B.R. 19, 25 (2d Cir. BAP 1997) – "Both management and its counsel have fiduciary duties to an estate in bankruptcy."

- In re Perez, 30 F.3d 1209, 1218-19 (9th Cir. BAP 1994) – "Counsel for the estate must keep firmly in mind that his client is the estate and not the debtor individually."

- In re Adam Furniture Indus., Inc., 158 B.R. 291, 301 (Bankr. S.D. Ga. 1993) – "Even though the law firm acts as attorney for the debtor in possession, it also has certain fiduciary duties to the estate, including insuring that the rights of the creditors are protected."

- In re Sky Valley, 135 B.R. 925, 929 (Bankr. N.D. Ga. 1992) – "Debtor's attorney's duty as fiduciary of the estate requires and active concern for the interest of the estate and its beneficiaries."

- In re United Utensils Corp., 141 B.R. 306, 309 (Bankr. W.D. Pa. 1992) – "An attorney for the debtor has a fiduciary duty not only to the debtor, but has a fiduciary obligation to act in the best interest of the entire estates, including creditors."

More recent cases, however, have held that DIP counsel does not owe a fiduciary duty to the estate, but in fact only owes a fiduciary duty to its client. These cases maintain that the provisions of the Bankruptcy Code and the Model Rules prohibit most, if not all, of the same type of conduct that would preclude DIP counsel from getting compensated under the "breach of fiduciary duty to the estate" theory employed by the cases mentioned above and others. In fact, more recent case law explains that the specific duties spelled out in the name of "fiduciary duty to the estate" can also be derived from the role of DIP counsel as fiduciary to the DIP or as an officer of the Court, as described in the Bankruptcy Code or the Model Rules. Three recent and significant cases holding that DIP counsel does not owe a fiduciary duty to the estate are listed below:

- In re Sidco, Inc., 173 B.R. 194, 196 (E.D. Cal. 1994) – The court expressly rejects the idea that DIP counsel is a fiduciary to the estate by stating: "The authorities cited by appellant to create a fiduciary duty of counsel to the estate is [sic] very weak. These non-binding cases speak of the attorney's fiduciary duty to the estate in unusual contexts, and not as a general principle. These cases do not overthrow…the basic tenet that 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. In fact, 11 U.S.C. § 327 guards against concurrent representation of both the creditor and a debtor-in-possession. Furthermore, it is the debtor-in-possession who ultimately manages the creditors' and shareholders' interests, while the attorney only advises the debtor. The debtor-in-possession, not the attorney, acts as the trustee to the estate."

- Hansen, Jones & Leta, P.C. v. Segal, 220 B.R. 434, 465 (D. Utah 1998) – "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 obligee 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(a).

- ICM Notes, Ltd. V. Andrews & Kurth, L.L.P., 278 B.R. 117, 126 (S.D. Tex. 2002) – "[I]n a bankruptcy proceeding, the debtor, secured creditors, unsecured creditors, and other related parties have different and competing interests. The Bankruptcy Code requires that a debtor's attorney be disinterested and not represent

the interest of any party to the bankruptcy case other than the debtor. 11 U.S.C. § 324. The Code contains prohibitions against conflicts of interest and requires that compensation be paid from an estate only if the services provided by counsel benefit the estate. 11 U.S.C. §§ 327, 328. A ruling that counsel of a debtor-in-possession owes a fiduciary duty to a particular creditor is contrary to the tenet of the Bankruptcy Code mandating that debtor's counsel be disinterested" (citations omitted).

Although it seems the trend in the case law and the statutory provisions should lead to the conclusion that DIP counsel only remains a fiduciary to the DIP, the concept of representing the "estate" should not be ignored. Counsel for the DIP or the Trustee must be aware that it has a variety of fiduciary obligations to the DIP and the estate, beyond the basic duties of loyalty, diligence and competence.

2. The Parameters of the Duty of Counsel to an Insolvent Debtor in Possession or Trustee

Whether defined as fiduciary duties to the DIP in its function as fiduciary to the estate or as fiduciary duties owed directly to the estate, attorneys representing the DIP or Trustee need to be aware of the various duties it has in assisting and overseeing the DIP or Trustee in its management of the estate. First, as discussed above, DIP counsel owes a duty of loyalty, diligence and competence to its client. Next, it owes a fiduciary duty to the Court, as it is an officer of the Court. Finally, federal courts have imposed additional duties deemed to be encompassed in DIP counsel's role as fiduciary to the DIP and/or the estate, which are discussed below:

a. Duty of DIP Counsel to Investigate the DIP/Estate

The majority view in this area is that this duty is derived from Bankruptcy Rule 9011, which requires that the signature of an attorney on every "petition, pleading motion or other paper served or filed in a case under the Code" constitutes a certification that the attorney has reviewed the document and "that to the best of the attorney's or part's knowledge, information, and belief after reasonable inquiry it is well-grounded in fact and is warranted by existing law…and that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation or the administration of the case." Fed. R. Bankr. P. 9011. There is a split of authority as to whether "reasonable inquiry," which is determined under the facts and circumstances of each case, should be "judged from the point of view of a reasonable bankruptcy practitioner or from a reasonable attorney who doesn't specialize in bankruptcy procedure." C.R. Bowles, Jr. & Nancy B. Rapoport, Has the DIP's Attorney become the Ultimate Creditors' Lawyer in Bankruptcy Reorganization Cases?, 5 Am.Bankr.Inst.L.Rev. 47, 83-85 (1997).

b. Duty to Address Motions Filed by Creditors

Another duty that causes fiduciary and ethical dilemmas is the duty to address motions or documents that are filed by creditors or other parties besides the DIP, including motions to convert, motions to appoint a trustee, or a plan proposed by a party other than the Debtor. Courts have held than when opposing such motions at the behest of the DIP, DIP counsel

must be careful not to represent the interests of the DIP or its management in a manner adverse to the estate or the creditors. In re Reed, 800 F.3d 104, 105 (8th Cir. 1989). However, other cases hold that courts should not disallow fees under a theory of breach of fiduciary duty to the estate when DIP counsel proposes and attempts to obtain confirmation of a plan opposed by creditors. In re Office Products of America Inc., 136 B.R. 983, 986-87 (Bankr. W.D. Tex. 1992) (stating "were we to hold here that pursuing these goals over the objections of creditors in and of itself created a conflict of interest, lawyers would be discouraged from even representing debtors in the face of creditor opposition for fear of not being paid.") Although there is no bright-line rule as to what is and is not a breach of a fiduciary duty, one court suggested:

> Counsel is charged with a 'duty of diligence' and should be expected in every reorganization to make a 'seasoned determination' whether the debtor is capable of achieving successful reorganization. Attorneys will not be compensated for vain attempts to resuscitate the debtor long after they should have given up the ghost.

In re DN Assoc., 144 B.R. 195, 220 (Bankr. D. Me. 1992).

c. Duty to Inform the Bankruptcy Court of a DIP's Violation of its Fiduciary Duty to the Estate and its Beneficiaries

Almost all cases dealing with this issue have held that DIP counsel has a duty to inform the bankruptcy court of a DIP's violation of its fiduciary duties to the estate and its creditors. In re JLM, Inc., 210 B.R. 19, 26 (2d Cir. BAP 1997). The following situations, have been held to be breaches of the fiduciary duty by failing to disclose:

- Undisclosed conflict of interest of another professional approved by the court. In re Sky Valley Inc., 135 B.R. 925, 937-38 (Bankr. N.D. Ga. 1992).

- Unauthorized use of estate funds by the DIP. Id.

- Undisclosed insider relationship between the DIP and a prospective purchaser of the DIP's assets. In re Chas. P. Young Co., 145 B.R. 131, 136 (Bankr. S.D.N.Y. 1992).

- Failure to disclose that the DIP was refusing to pursue claims against insiders. In re United Utensils Corp., 141 B.R. 306, 309 (Bankr. W.D. Pa. 1992).

- Failure to disclose that management of the DIP was "incompetent " In re Rivers, 167 B.R. 288, 300 (Bankr. N.D. Ga. 1994).

- Failure to disclose conversion of estate property by the DIP. In re Brennan, 187 B.R. 135 (Bankr. D. N.J. 1995).

- Failure to disclose concealment of estate assets. In re Ward, 894 F.2d 771, 776

(5th Cir. 1990).

d. Duty to Supervise or "Police" the Debtor

DIP counsel has a duty to closely and carefully monitor the Debtor and DIP to ensure that the interests of the estate are being met. In re Wilde Horse Enter's Inc., 136 B.R. 830, 840 (Bankr. C.D. Cal. 1991) (requiring attorney to take an active role in protecting the interests of the estate, beneficiaries, and unsecured creditors). While there is some support for the notion that such "policing" should be left to the creditors' committee, the majority of courts considering this issue have found it to be a duty. In re Dieringer, 132 B.R. 34 (Bankr. N.D. Cal. 1991) (arguing that the role of policeman should be left the creditors' committee). A few of the cases holding that DIP counsel has a duty to police are listed below:

- Matter of Davison, 79 B.R. 859 (Bankr. W.D. Mo. 1987) – Denying counsel all requested fees due to failure to prevent estate from incurring large unpaid postpetition debt.

- In re Sky Valley, 135 B.R. 925 (Bankr. N.D. Ga. 1992) – Reducing attorneys fees because DIP counsel failed to supervise auction process allowing funds to leave the estate without required court approval.

- In re Wilde Horse Enters. Inc., 136 B.R. 830 (Bankr. C.D. Cal. 1991) – Finding failure of duty to police by allowing DIP to attempt to sell estate's assets to boyfriend/landlord for below-market value.

e. Additional Duties

- Duty to maximize the value of the estate, including by pursuing possible recoveries against insiders. In re R & R Associates Of Hampton, 402 F.3d 257 (1st Cir. 2005)(counsel to the debtor in possession has broad duties that "include the maximization of the value of the debtor's assets, and the recovery of property for the benefit of the bankruptcy estate. . . .").

- Duty to "carefully monitor each case and encourage conversion or dismissal without delay when it becomes apparent that reorganization is no longer feasible or that wrongdoing is taking place." In re Pacific Forest Indus., Inc., 95 B.R. 740, 744 (Bankr. C.D. Cal. 1989).

- Duty to disclose the debtor's diversion of DIP funds. In re Swansea Consolidated Resources, 155 B.R. 28, 38 n. 14 (Bankr. D.R.I. 1993).

- Duty to maximize the estate. In re Keene Corp., 205 B.R. 690, 691 (Bankr. S.D.N.Y. 1997).

- Duty to exercise independent professional judgment on behalf of the estate and to disclose any actual or potential conflicts of interest with the estate. In re Smitty's Truck Stop, Inc., 210 B.R. 844, 850 (10th Cir. BAP 1997).

C. The Fiduciary Duty of Counsel to an Official Committee

Members of the Official Committee of Unsecured Creditors (the "Committee") and its counsel owe a fiduciary duty to all unsecured creditors. Like DIP counsel, Committee counsel owes a duty of loyalty, care, and diligence to its client, the Committee. However, courts have held that Committee counsel is also bound by the same fiduciary responsibilities as the Committee. While the Committee and Committee counsel are not necessarily fiduciaries to the entire estate, they must use care to ensure that creditors' interests are met. Committee counsel is not a fiduciary only to the Committee, but to the creditor class as a whole. Such a duty can cause tension between Committee counsel's ethical obligations to its client, the Committee, and its mandated fiduciary duty to all unsecured creditors when counsel is concerned that the Committee is not acting in the best interests of all unsecured creditors.

1. The Scope of Committee Counsel's Fiduciary Duties

a. Duty to the Class of Creditors, Not an Individual Creditor

Committee counsel has a fiduciary duty to all unsecured creditors. In re General Homes Corp., 181 B.R. 87 (Bankr. S.D. Tex. 1994). However, this duty does not mean that Committee counsel cannot perform functions for the Committee that are not in the best interest of individual creditors. In re Circle K Corp., 199 B.R. 92 (Bankr. S.D.N.Y. 1996) (holding that Committee's constituents do not thereby become clients); Piccioto v. Schreiber, 260 B.R. 242 (D. Mass. 2001) (holding that Committee counsel owes no duty to individual creditors). In fact, as long as it does not use confidential information or improper advantage due to its representation of the Committee pursuant to Model Rule 1.9, Committee counsel may pursue litigation against an individual creditor. In re Electric Materias Co., 160 B.R. 1016 (Bankr. W.D. Mo. 1993). Additionally, former Committee counsel may represent a Liquidating Trust in litigation against individual creditors under the bankruptcy plan. In re USN Communications, Inc., 280 B.R. 573 (Bankr. D. Del. 2002).

b. Duty to Protect the Estate

While Committee counsel does not owe a fiduciary duty to the estate, it should, like DIP counsel, work to perform its responsibilities in a way that does not waste estate assets. Various courts have discussed this responsibility of Committee counsel to help protect the estate as it represents the unsecured creditors:

- In re Thrifty Oil Co., 205 B.R. 1009 (Bankr. S.D. Cal. 1997); In re Keen Corp., 205 B.R. 690 (Bankr. S.D.N.Y. 1997) – Committee counsel is expected to work with DIP counsel to resolve plan issues, rather than prepare numerous committee draft plans and objections to debtor plans and disclosures.

- In re Cumberland Farms, 154 B.R. 9 (Bankr. D. Mass. 1993); In re Dow Corning Corp., 199 B.R. 896 (Bankr. E.D. Mich. 1996) – Committee counsel should not be overly involved in every aspect of the DIP's business as excessive litigation and action outside the interest of its constituents is a waste of estate assets.

- In re New England Metal Co., Inc., 155 B.R. 38 (Bankr. D. R.I. 1993) – Committee counsel should not act as "mere spectator" and rack up fees without doing anything to benefit the creditors' position.

- In re Rancourt, 207 B.R. 338 (Bankr. D. N.H. 1997); In re Wilson Foods Corp., 31 B.R. 272 (Bankr. W.D. Okla. 1983) – Committee counsel should take its factual and legal analysis to court when there are issues in the case that have a significant impact on creditor distributions.

- In re Auto Parts Club, Inc., 211 B.R. 320 (Bankr. 9th Cir. 1997) – Committee counsel should scale back services when it is clear that creditors will not receive a distribution.

2. Ability of Committee Counsel to Concurrently Represent One or More Creditors of the Same Class

Pursuant to 11 U.S.C. § 1103, representation of one or more creditors of the same class represented by the Committee is not considered an adverse interest. Although Committee counsel has a duty to all creditors in the class, potential conflicts between duties to the Committee and duties to a separate creditor are inevitable. Various courts have evaluated such conflicts, ruling on a case-by-case basis:

- Matter of Oliver's Stores, Inc., 79 B.R. 588 (Bankr. D.N.J. 1987); In re Grant Broadcasting of Philadelphia, Inc., 71 B.R. 655 (Bankr. E.D. Pa. 1987) – Counsel bringing litigation for individual creditor that was potentially adverse to the Committee required disqualification as Committee counsel.

- Matter of Whitman, 101 B.R. 37 (Bankr. N.D. Ind. 1989) – Counsel representing an insurance company sought to be retained by the Committee was disallowed as Committee counsel.

- In re Rusty Jones, Inc., 107 B.R. 161 (Bankr. N.D. Ill. 1989) – Creditors' committee was not precluded from employing law firm which also represented individual creditors, absent showing of conflict of interest between individual creditors and committee as a whole.

- In re Technology for Energy Corp., 53 B.R. 32 (Bankr. E.D. Tenn. 1985) – Counsel for two shareholders appointed as Committee special Counsel.

While once in common practice, it is now uncommon for Committee counsel to represent concurrently individual creditors.

3. Duty of Confidentiality and the New Bankruptcy Law Amendments

Although there is no statutory privilege protecting communications between DIP counsel and the Committee counsel, some courts have recognized that an implied duty of confidentiality exists in order to allow a Committee to fulfill its duty under section 1103(c)(2) of the Code to "investigate the acts, conduct, assets, liabilities, and financial condition of the

debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan." In re Wilson Foods Corp., 31 B.R. 272 (Bankr. W.D. Okla. 1983) (stating that the duties of the committee require it to dig deep into all aspects of the debtor and its business). In fact, some courts have even insulated sensitive information after recognizing this need to protect the debtor's disclosures to the Committee. In re Handy Andy Home Imp. Centers, Inc., 199 B.R. 376 (Bankr. N.D. Ill. 1996); In re Texaco Inc., 79 B.R. 560 (Bankr. S.D.N.Y. 1987).

However, the new bankruptcy law amendments under the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005" ("BABCPA") would: 1) require Committees to provide their non-committee member constituents access to information; 2) subject Committees to orders that require reports or disclosures to those constituents; and 3) require Committees to solicit and receive comments from their constituents. This amendment will likely change the way DIP counsel shares confidential information with Committee counsel, both in how much information it shares and the manner by which it shares it. It remains to be seen how this amendment will be implemented and the effect it will have on the flow of information and communications between the DIP and the Committee.

D. Conventional Professional Liability for Attorneys in Bankruptcy Cases

Attorneys practicing bankruptcy law have a host of substantive legal pitfalls that must be avoided. Here the potential liability sounds in conventional malpractice theory, which is governed by the relevant standard of care. Counsel to a debtor in possession has the duty to preserve critical procedural and substantive rights. Certain rights of a debtor in possession, once lost, cannot be regained. Attorneys for creditors likewise must meet the standard of care for tasks they undertake. The following is a list of some areas where attorneys practicing in bankruptcy can fall victim to malpractice liability:

- 11 U.S.C. § 365(d) – The right to extend time to assume or reject under section 365(d)(4) must be utilized within 60 days after the date of the order for relief, or the lease is deemed rejected. In re Southern Motel Associates, Ltd., 81 B.R. 112 (Bankr. M.D. Fla. 1987) (stating that a debtor's failure to timely assume a lease of nonresidential real property will not be excused simply because the lessor did not suffer any monetary losses, or because strict application of the automatic rejection provision will result in the forfeiture of substantial assets). If this 60-day deadline is missed, the client will lose its right to assume a lease, and that right cannot be regained. In re Esmizadeh, 272 B.R. 377 (E.D.N.Y. 2002) (holding that trustee failed to assume lease in timely manner, and thus lost any right to assert ownership interest in lease, where trustee did not file motion to assume or reject lease or express to landlord any clear intention to assume lease within either sixty days of petition date or within sixty days of discovery of lease's existence).

- 11 U.S.C. § 1121 – The right to extend time for plan exclusivity can also be lost. Matter of Jasik, 727 F.2d 1379 (C.A.5 (Tex.) 1984) rehearing denied, 731 F.2d 888 (stating that where chapter 11 debtors proposed no reorganization plan within exclusive statutory period, did not petition court for extension of time and had not proposed plan when trustee was appointed, they no longer had exclusive right to

submit such plan). See also In re River Village Associates, 181 B.R. 795 (E.D.Pa.1995).

- Statute of Limitations – There are a variety of rights within the Bankruptcy Code that are subject to deadlines which, when lost by missing that deadline, cannot be regained. For example, Section 546 of the Bankruptcy Code sets forth limitations on the avoiding powers. Specifically, it states:

> (a) an action or proceeding under section 544, 545, 547, 548 or 553 of this title may not be commenced after the earlier of –
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> 1) the later of –
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> (A) 2 years after the entry of the order for relief; or
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> (B) 1 year after the appointment or election of the first trustee under section 702, 1104, 1163, 1202, or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A); or
>
> 2) the time the case is closed or dismissed.

See In re American Pad & Paper, 319 B.R. 791 (D. Del. 2005) (holding that the original 2-year limitation of section 546(a)(1)(A) applies to an interim trustee appointed just prior to the expiration of the period, and still serving as interim trustee on the expiration thereof, noting that "the rights involved are not the trustee's. Rather it is the bankrupt entity whose rights are at stake, and, at a minimum, a bankrupt entity is allotted two years"); In re The Mediators, Inc., 105 F.3d 822 (2d. Cir. 1997) (two years statute of limitation applied following the date of an involuntary filing); In re Coastal Group, Inc., 13 F.3d 81 (3d. Cir. 1994) (same).

- 11 U.S.C. § 501 – Counsel should be aware that filing a proof of claim can waive a jury trial right in many circumstances. Langenkamp v. Culp, 111 S.Ct. 3001 (1990). Also, signing a proof of claim can expose an attorney either to liability, or at least "lawyer as witness" issues. Finally, counsel does not want to miss the bar date and thus be unable to file a proof of claim. Jones v. Chemetron Corp., 212 F.3d 199 (3d Cir. 2000) (stating that ignorance of one's own claim does not constitute excusable neglect for late filed claim).

- Failure to file a Bankruptcy Rule 2019 statement when representing more than one client – Rule 2019 arguably requires counsel with multiple clients to file a Rule 2019 statement and courts have been so holding. See In re USG Corp., Case No. 01-2094 (JKF), Revised Order Requiring Filing of Statements Pursuant to Fed. R. Bankr. P. 2019, Docket No. 6852 (Oct. 22, 2004) and In re Owens Corning, Case No. 00-3837 (JKF), Order Requiring Filing of Statements Pursuant to Fed. R. Bankr. P. 2019, Docket No. 12574 (Aug. 25, 2004).

II. Accountants, Investment Bankers and Financial Advisor Liability

A. Causes of action against auditors, accountants, financial advisors and investment bankers.

Many times when a reorganization case fails, or when an entity either files a case under chapter 7 of the Bankruptcy Code, or an involuntary bankruptcy is commenced, the Trustee may seek to find various professionals at fault for the demise of the entity. Claims pursued in connection with the failure of businesses have integrated fraud, fraudulent concealment, negligent misrepresentation, malpractice, deepening insolvency, breach of contract, and aiding and abetting as causes of action. Potential defendants have included accountants and auditors who have negligently or fraudulently issued false financial statements, investment bankers who have participated in the issuance of fraudulent debt securities, and even the company's attorneys. Some examples of cases addressing these kinds of claims are the following:

- Smith ex rel. Estates of Boston Chicken, Inc., v. Aurthur Anderson L.L.P., 175 F.Supp.2d 1180 (D. AZ. 2001)(action against debtor's accountants and public offering underwriters for claims that they acted in concert with the officers and/or directors to increase the debtor's insolvency by falsely and unlawfully misrepresenting its true financial condition, while at the same time concealing the misconduct and breached of fiduciary duty by the officers and/or directors.)

- In re Merry-Go-Round Enterprises, Inc., 244 B.R. 327 (Bankr. D.Md. 2000) (a major accounting and consulting firm was sued by the Chapter 7 bankruptcy trustee after the case had been converted from a Chapter 11 reorganization to a Chapter 7 liquidation. The trustee alleged that the reorganization failed due to a number of errors by the consulting firm, which had served as the debtor's turnaround specialist during the reorganization. The complaint filed against the consulting firm contained allegations of fraud, fraudulent concealment and negligence/malpractice. One the eve of trial the consulting firm settled the litigation for $185 million.)

- Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A., 137 F. Supp 2d 502 (S.D.N.Y. 2001) aff'd, 322 F.3d 147 (2nd Cir. 2003)(Claims against management consulting company (who contractually was to provide debtor with advice concerning management, financing, and marketing, was to assist in "strategic planning," and was a wholly owned subsidiary of another defendant) survived motion for summary judgment upon allegations that defendant, in carrying out these duties, acted negligently (and therefore breached a duty of care and committed common law negligence).)

Deepening insolvency is increasingly recognized by bankruptcy courts as an independent cause of action under which a bankrupt company or its representatives may recover damages caused by third parties – such as officers and directors, accountants, and other professionals, and even lending institutions – who have either mismanaged or controlled the bankrupt company or misrepresented its financial condition in such a way as to cause or conceal the company's slide into insolvency.

In Schacht v. Brown, 711 F.2d 1343 (7th Cir. 1983), the representative of a bankrupt company asserted that the company's auditors, by preparing unqualified opinion letters and certifying inaccurate financial statements, assisted the company's insiders in a scheme to continue the company in business despite its insolvency, and thereby injured the company. The Court concluded that the claims were actionable, finding that a company may be harmed, rather than benefited, where its life is artificially prolonged while its insolvency deepens through increased exposure to creditor liability.

In 2001, the Third Circuit Court of Appeals in the case of Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 355 (3d Cir. 2001), held that deepening insolvency may give rise to a cognizable injury and that it therefore constitutes a valid and separate cause of action under Pennsylvania law.

B. Limitations on Recovery - *In Pari Delicto*

Before pursuing an action against accountants, consultants or financial advisors it is important to consider the common-law defense of *in pari delicto*, "where the wrong of the one party equals that of the other, the defendant is in the stronger position" and a court will not "administer a remedy." 34 Tex. Jur. 3d "Equity" § 31 (2002); see also Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A., 137 F. Supp. 2d 502 (S.D.N.Y. 2001), aff'd, 322 F.3d 147 (2nd Cir. 2003). The doctrine of *in pari delicto* provides that a plaintiff may not assert a claim against a defendant if the plaintiff bears fault for the claim. See Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 355 (3d Cir. 2001) citing Cenco Inc. V. Seidman & Seidman, 686 F.2d 449, 453-54, "a participant in a fraud cannot also be a victim entitled to recover damages, for he cannot have relied on the truth of the fraudulent representation, and such reliance is an essential element in a case of fraud."

Claims and causes of action belonging to a corporate debtor are property of the estate within the meaning of 11 U.S.C. § 541 and a trustee has the authority to sue on behalf of a debtor. Although the Bankruptcy Code allows claims against third parties that participated in the misconduct, the ability to pursue such claims is not unlimited. Defenses based upon doctrines of imputation and *in pari delicto* may be raised. The debtor or bankruptcy trustee steps into the shoes of the company and can take no greater rights than the company itself had. 11 U.S.C. § 541(a)(1).

For example, in Goldin v. Primavera Familienstiftung, TAG Associates, Ltd. (In re Granite Partners, L.P.), 194 B.R. 318 (Bankr. S.D.N.Y. 1996), the doctrine of *in pari delicto* was applied to prevent a chapter 11 trustee from suing brokers who allegedly aided and abetted a debtor's controlling shareholder in its alleged acts of corporate mismanagement. The court there held that the knowledge and guilty conduct of the controlling shareholder had to be imputed to the debtor corporation.

Often defendants will invoke the doctrine of *in pari delicto* to insulate themselves from liability for their own wrongdoing, simply by alleging that their co-conspirator and client in the endeavor was the debtor. Notably, the court In re Baker O'Neal Holdings, 2004 WL 771230 (S.D. Ind. 2004) stated in rejecting *in pari delicto* as a basis for dismissing a company's complaint against its former auditors:

> The risk of a liberal application of *in pari delicto* is that tortfeasors preparing to defraud an entity could potentially immunize themselves from liability simply by enlisting the help of an executive in the victim-corporation…. Outside of a fraudulent conveyance scenario, the best case for not applying the *in pari delicto* defense is where the insider and the third party tortfeasor were essentially acting as co-conspirators.

Id., 2004 WL 771230 at *10.

1. Adverse Interest Exception

The adverse interest exception provides that fraudulent conduct will not be imputed to the corporation if the officer's interests were adverse to the corporation and "not for the benefit of the corporation." Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d at 359(citations omitted). The imputation of the wrongful conduct of an officer, director or employee to a corporation is governed by agency principles. Under these principles, the misconduct of managers acting within the scope of their employment will normally be imputed to the corporation. The application of this exception is dependent on state law. See also In re CBI Holding Co., Inc., 247 B.R. 341, 364-65 (S.D.N.Y. 2000) ("[A] corporation whose management was involved in an accounting fraud is not barred from asserting claims for professional malpractice in not detecting the fraud, provided the corporation had at least one decision-maker in management or among its stockholders who was innocent of the fraud and could have stopped it.").

When an agent is acting adversely to the interest of the principal the knowledge and conduct are not imputed to the principal, unless the principal benefited from the misconduct. Smith v. Arthur Andersen LLP, 175 F. Supp. 2d 1180, 1199 (D. Ariz. 2001); Wright v. BankAmerica Corp., 219 F.3d 79, 87 (2d Cir. 2000).

The adverse-interest exception will not always bar the imputation of misconduct to the trustee or committee in two situations. One is where the agent of the corporation is a sole shareholder, or the other instance is where all relevant decision-makers were involved in the fraud and there is sufficient unity between the actors and the corporation. Smith v. Arthur Andersen, 175 F. Supp. at 1199.

C. Use of Other Code Sections After Lafferty

The Third Circuit's decision in Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340 (3d Cir. 2001) has been used to defeat claims against professionals by applying the *in pari delicto* defense. However, the Third Circuit has explicitly limited its holding in Lafferty to cases in which the trustee is acting under section 541. McNamara v. PFS (In re The Personal and Business Insurance Agency), 334 F.3d 239, 246 (3d Cir. 2003) (the holding in Lafferty does not extend to actions brought under Code sections other than section 541 - the bankruptcy trustee sought to pursue fraudulent-conveyance claims against a lender. In that case, the sole owner and CEO of the company,

borrowed funds from the lender and pocketed the funds while repaying some of the loans with company monies. The lender argued that the trustee's claims were barred by *in pari delicto*. The defendant argued the sole-actor exception required the sole owner's conduct be imputed to the trustee. The Third Circuit concluded that where the bad actor has been eliminated and the trustee represents the interests of innocent creditors, Pennsylvania law recognizing equitable defenses such as imputation may not act as a total bar to recovery).

In pursuing actions to recover property for the general benefit of all creditors of the estate, the Trustee is not limited to acting under section 541. Rather, the Trustee has the authority to prosecute general claims of the debtor's creditors (claims that are common to all creditors, as opposed to claims which accrue only to an individual creditor or group of creditors) under section 544. See, e.g., PHP Liquidating, LLC v. Robbins, 291 B.R. 603, 609 (D. Del. 2003); Zilkha Energy Company v. Leighton, 920 F.2d 1520, 1523 (10th Cir. 1990); In re Porter McLeod, Inc., 231 B.R. 786, 792 (D. Col. 1999).

The *in pari delicto* doctrine does not apply when the trustee stands in the shoes of a hypothetical or actual creditor and sues under section 544 of the Bankruptcy Code. In Pereira v. Cogan, Sherman, et al., 2001 U.S. Lexis 246 (S.D.N.Y. 2001), the defendants sought to dismiss a trustee's breach of fiduciary duty claim against former directors of a debtor. The court rejected defendants' contention that the trustee could not bring suit on behalf of third party creditors. "[W]here the injury is to all creditors as a class, it is the creditors who lack standing and the [t]rustee who may bring a claim based on that generalized injury." Id. at *351. The court reasoned that the trustee had standing to pursue a claim against the defendants, brought solely for the benefit of creditors.

However, in Goldin v. Primaverva Familienstiftung Tags Assocs. (In re Granite Partners, L.P.), 194 B.R. at 324 the court held that the trustee, pursuant to section 544, cannot pursue personal claims belonging to select creditors.

If on the other hand the alleged injury is to all creditors, a trustee may bring a claim based on that generalized injury. PHP Liquidating, LLC v. Robbins, 291 B.R. 603, 609 (D. Del. 2003) (section 544 allows trustee to pursue general claims); Kalb, Voorhis & Co. v. American Fin. Corp., 8 F.3d 130, 132-33 (2d Cir. 1993) (applying Texas law, on alter ego claim, trustee had exclusive standing where acts "harmed all creditors equally, [and] such claims are property of the bankruptcy estate and are not assertable by individual creditors"); Wooten v. Loshbough, 951 F.2d 768, 770 (7th Cir. 1991) (trustee had exclusive standing to assert RICO claim against corporation looted by officers and accounting firm for personal gain); St. Paul, 884 F.2d at 696-99 (alter ego claim asserted exclusively by trustee under Ohio law due to generalized nature of injury).

These cases establish that "[i]f a claim is a general one, with no particularized injury arising from it, and if that claim could be brought by any creditor of the debtor, the trustee is the proper person to assert the claim, and the creditors are bound by the outcome of the trustee's action." Kalb, 8 F.3d at 132. In In re Porter McLeod, 231 B.R. 786 (D. Colo. 1999), the trustee brought suit pursuant to section 544(a) alleging that defendant law firms committed malpractice and aided and abetted a breach of fiduciary duty in their relationship with the debtor. The law firm alleged that the trustee lacked standing to assert claims under §544(a) and that the trustee's authority to bring the claims was limited to §541. The Court

disagreed, ruling specifically that in §544(a), Congress crafted a legal fiction that allows the trustee to assume the role of a creditor along with the creditor's ability to invoke any available state law remedies. Id. at 792 (citing Zilkha Energy Co. v. Leighton, et al., 920 F.2d 1520, 1523 (10th Cir. 1990)).

D. Indemnity Agreements

Frequently investment bankers and/or financial advisors are retained in chapter 11 cases to provide advice and various other services to trustees, debtors in possession, and official committees regarding the reorganization or possible liquidation of estate assets. Investment bankers and financial advisors are considered "professional persons" and fall within purview of sections 327(a) and 1103(a) of the Bankruptcy Code. Section 328(a) authorizes the employment of professionals on any reasonable terms and conditions of employment, subject to court approval.

Since the settlement of a lawsuit against the accountants advising the debtor's estate in In re Merry-Go-Round Enters., Inc., 244 B.R. 327 (Bankr. D. Md. 2000), many professionals retained in bankruptcy proceedings have sought indemnification against liability for their own negligence.

The Third Circuit in In re United Artists Theatre Co., 315 F.3d 217, 227 (3d Cir. 2003) allowed such indemnification provisions after a fact-specific inquiry into whether they were reasonable under the circumstances of the case. The Third Circuit stated that when considering non-consensual releases, the court should look for fairness, necessity to the reorganization, specific factual findings that support these conclusions, and whether the non-consensual releases were given in exchange for fair consideration. Id. In re Metricom, 275 B.R. 364 (Bankr. N.D. Cal. 2002) (holding there is no per se rule against indemnification provisions but proponent must establish reasonableness of the subject provisions); Unsecured Creditors' Comm. v. Pelofsky (In re Thermadyne Holdings, Corp.), 283 B.R. 749 (B.A.P. 8th Cir. 2002) (holding there is no *per se* rule against indemnification provisions but the reasonableness of said provisions must be consistent with market conditions, current economic conditions and the potential economic costs to the bankruptcy estate). See also Unsecured Creditors Comm. v. Pelofsky (In re Thermadyne Holdings Corp.), 283 B.R. 749 (B.A.P. 8th Cir.2002); In re Metricom, Inc., 275 B.R. 364 (Bankr.N.D.Cal.2002) (rejecting indemnification of the advisor to the bondholders' committee, as unreasonable where the debtor and official committee of unsecured trade creditors retained two other financial advisors without such indemnification agreements, and there was no showing that such an agreement was necessary); In re Comdisco, Inc., 2002 WL 31109431 (N.D. Ill. 2002)(reasonableness of indemnity for professional advisors depends on the fact of each case); In re DEC International, Inc., 282 B.R. 423 (W.D.Wis. 2002) (indemnity of bankruptcy professionals not per se unreasonable but must be scrutinized with care).

III. Procedural Issues Related to Professional Liability Claims

A. Jurisdictional Limitations

Professional liability claims for postpetition acts or omissions have been repeatedly held to be claims that "arise in" the bankruptcy case, or are proceedings arising under title 11 or related to a case under title 11, within the meaning of 28 U.S.C. § 1334(b). Grausz v. Englander, 321 F.3d 467 (4th Cir. 2003)(malpractice complaint filed by chapter 11 debtor against his bankruptcy counsel removed to district court was properly in federal court under "arising in" jurisdiction). See also In re Southmark Corp., 163 F.3d 925, 931 (5th Cir.) *cert. denied*, 527 U.S. 1004, 119 S.Ct. 2339, 144 L.Ed.2d 236 (1999) (finding jurisdiction over accountant malpractice claims) and In re V&M Management, Inc., 321 F.3d 6, 9 (1st Cir. 2003).

An action by a trustee for legal malpractice against chapter 11 debtor's counsel is generally considered a "core" proceeding. Woodward v. Sanders (In re SPI Communications Mktg., Inc.), 112 B.R. 507, 510-11 (Bankr.N.D.N.Y.1990).

For malpractice claims arising post-confirmation, however, even when the plan provides for a litigation trust to pursue them for the benefit of creditors, the Third Circuit Court of Appeals has held that "related to" subject matter jurisdiction is lacking. In In re Resorts International, Inc., 372 F.3d 154 (3d Cir. 2004), the trustee of a litigation trust sued an accounting firm for professional negligence and breach of contract for work it performed for the trust. The Bankruptcy Court held that it lacked subject matter jurisdiction. The District Court reversed. The Third Circuit reversed and remanded.

The trustee's principal claim in Resorts was that the accountants incorrectly reported in an audit that accrued interest on litigation trust accounts belonged to the debtor rather than to the trust. Underlying this claim was a suit between the Litigation Trust and the debtor over entitlement to the accrued interest. The trustee brought the malpractice action against the accounting firm in the bankruptcy court seven years post-confirmation. The bankruptcy court granted the accounting firm's motion to dismiss for lack of subject matter jurisdiction, finding there was no "related to" or "core" jurisdiction.

The District Court held "the terms on which the litigation trust was created and its practical role in the Plan lead to the conclusion that claims arising from professional misconduct in the Trust's affairs are sufficiently related to the bankruptcy case to be within the jurisdiction of the Bankruptcy Court." Id. The Third Circuit reversed, reasoning that the debtor had reorganized, had assigned all litigation claims to the trust, and was not a party to the trustee's lawsuit. The court of appeals further reasoned that the lawsuit did not require a court to interpret the plan or the litigation trust agreement. Id. at 170. Nor did the potential recovery for beneficiaries of the trust confer related to jurisdiction, the court stated. This was so because the creditors had traded their creditor status against the debtor to interestholders in the trust. Id.

B. Potential *Res Judicata* Effect of A Final Fee Order

A party considering a malpractice claim against an estate professional should take into account the effect of approval of the professional's final fee application. In Grausz v. Englander, 321 F.3d 467 (4th Cir. 2003), the court of appeals held that the approval by the bankruptcy court of a law firm's unopposed final fee application was *res judicata* of the malpractice claim later filed by the debtor. The court of appeals in Grausz applied the following factors to analyze the *res judicata* effect of the fee order:

> 1) the prior judgment was final and on the merits, and rendered by a court of competent jurisdiction in accordance with the requirements of due process; 2) the parties are identical, or in privity, in the two actions; and, 3) the claim[ ] in the second matter [is] based upon the same cause of action involved in the earlier proceeding.

Id. at 472 (quoting In re Varat Enters., Inc., 81 F.3d 1310, 1315 (4th Cir.1996).

Grausz, the debtor, argued that he was not a party in interest to the fee applications, since when they were filed a case trustee had been appointed. The court of appeals rejected that argument, on the specific facts of Grausz's case, namely, that his disclosure statement provided that his plan would not make distributions sufficient to pay all nondischargeable priority claims. The court therefore reasoned that Grausz had a pecuniary interest because his priority creditors would receive more distributions to the extent his counsel's fees were reduced. This fact-specific holding is very important to the case, as arguably the debtor could have otherwise defeated an essential element of the *res judicata* defense.

The Fourth Circuit's analysis of the third *res judicata* element (the "same cause of action" test) is also interesting:

> Generally, we say that "claims are part of the same cause of action when they arise out of the same transaction or series of transactions, or the same core of operative facts." The "core of operative facts" in the two actions here--the fee application proceeding and the malpractice action--are the same. Both actions relate to the nature and quality of legal services the Linowes firm provided to Grausz in connection with the bankruptcy proceeding.

Id. at 473 (citation omitted). The court further reasoned that "[b]y granting the [law firm's] second and final fee application, the bankruptcy court impliedly found that the firm's services were acceptable throughout its representation of Grausz." The court could have ended it analysis there, but went on to discuss certain facts specific to the case. Id. at 473 ("Although the three formal elements for claim preclusion are present, our inquiry is not complete, at least not in this case.") The court stated that "[b]ecause it might not appear at first blush that a malpractice claim should be asserted in a bankruptcy fee proceeding, two practical considerations should be taken into account." Id. These were that (1) "Grausz knew or should have known there was a real likelihood that he had a malpractice claim against the

firm" by the time the final fee application was filed, and (2) "Procedural mechanisms [i.e., conversion of a contested matter to an adversary proceeding] were therefore available for Grausz to raise his malpractice claim in connection with the fee proceeding". Grausz argued that forcing him to litigate in the Bankruptcy Court would have forced him to waive his right to trial by jury. The court did not decide the jury trial issue, instead stating that if there was a jury trial right, the proceeding could be heard by the district court. The question left by this supplemental analysis is whether it provides a basis for an aggrieved party to argue that they should not be barred from bringing the claim, even though the *res judicata* elements may be met as in Grausz.

C. Lack of Standing to Bring Claims on Behalf of Creditors

Malpractice claims that arise postpetition are property of the bankruptcy estate. A Trustee therefore has standing to bring the claims. A trustee may elect to pursue the claim in state court before jury or as a core proceeding in the bankruptcy case. See In re R & R Associates, 402 F.3d at 265. For claims that arise prepetition, there can be several standing issues. One major impediment to standing, usually applicable to a case trustee, is the doctrine of *in pari delicto*, discussed herein in section II.B above. Under the "Wagoner rule", a trustee lacks standing to sue third parties where the fraud was perpetrated by the debtor itself. See Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir.1991)("[A] bankruptcy trustee has no standing generally to sue third parties on behalf of the estate's creditors, but may only assert claims held by the bankrupt corporation itself.") The Wagoner rule applies to professional malpractice claims. Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094 (2d Cir.1995).

In In re The Bennett Funding Group, Inc., 336 F.3d 94 (2d Cir. 2003), the trustee faced a challenge to standing, under the Wagoner rule, with respect to his claims for malpractice and other causes of action against a debtor's accountants and attorneys for their alleged role in a Ponzi scheme. The trustee vigorously pursued an exception to the Wagoner bar to standing, wherein one or more members of management were innocent. The trustee based his arguments on two cases, Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld L.L.P., 212 B.R. 34 (S.D.N.Y.1997), and In re CBI Holding Co., 247 B.R. 341, 364-65 (Bankr.S.D.N.Y.2000). The trustee argued that Wechsler stands for the proposition that to apply the rule which imputes fraud to the debtor and bars the trustee from bringing suit, "all relevant shareholders and/or decision makers [must be] involved in the fraud." Wechsler, 212 B.R. at 36. The court of appeals rejected this argument, noting that in CBI the court required that "imputation applies unless at least one decision maker in a management role or amongst the shareholders is innocent *and* could have stopped the fraud". Id. at 101.

Another basis for a lack of standing is that the claims are fundamentally owned not by the estate but by individual creditors or investors. E.g., In re Dublin Securities, Inc., 197 B.R. 66 (S.D.Oh. 1996)(trustee lacked standing to assert malpractice claims against attorneys and law firms that had represented debtors-securities companies in connection with fraudulent intrastate penny stock sales, which claims belonged to defrauded investors).

D. Right to Jury Trial

Whether a debtor or other party can have a trial by jury in a malpractice claim against an estate professional may depend on the circuit in which the case is pending. In re Southmark, 163 F.3d 925, 935 n.16 (5th Cir.1999) cert. denied, 527 U.S. 1004, 119 S.Ct. 2339, 144 L.Ed.2d 236 (1999) ("[D]ebtor does not waive the right to a jury trial by filing a voluntary bankruptcy case."). Compare Billing v. Ravin, Greenberg & Zackin, P.A., 22 F.3d 1242, 1253 (3d Cir.1994) (treating debtors' malpractice claim, asserted as a defense to lawyer's fee petition, as an equitable dispute that did not give rise to the right to a jury trial).

IV. Remedies

A. Disgorgement

For any estate professional, disgorgement of fees would likely be the first form of remedy for a finding of professional liability arising post-petition. By definition, a professional who by action or inaction caused harm to the estate should not be entitled to a full award of fees, given that such an award must meet the "benefit to the estate" test of section 503(a), as well as the standards of section 330. Unlike a malpractice claim, in which the plaintiff must prove damages and proximate cause, disgorgement for failure to disclosure does not require causation.

B. Bankruptcy Rule 9011 Sanctions

Bankruptcy Rule 9011 requires a motion for sanctions to be made "separately from other motions." Fed. R. Bankr. P. 9011(c)(1)(A). It may also be required, as it is in the Third Circuit, that motions for sanctions must be filed before the entry of final judgment. See Mary Ann Pensiero, Inc. v. Lingle, 847 F.2d 90, 100 (3d Cir.1988).

It is generally accepted that the body of law interpreting Fed. R. Civ. P. 11 is equally applicable to Bankruptcy Rule 9011. E.g., Landon v. Hunt, 977 F.2d 829 (3d Cir. 1992)("Bankruptcy Rule 9011 is the equivalent sanctions rule under Title 11. The policies underlying both rules are the same. . . . "), 10 Lawrence P. King, Collier on Bankruptcy § 9011.02[3] (15th ed. rev. 1997) (noting precedents developed under civil procedure rule 11 are of significant use in applying bankruptcy rule 9011).

Fed.R.Civ.P. 11 has been held to permit "[c]omplete or partial fee shifting [as] ... one form of disciplinary action which a court may invoke in appropriate circumstances." Gaiardo v. Ethyl Corp., 835 F.2d 479, 483 (3d Cir. 1987).

It appears that the actual test applied for Rule 9011 sanctions can vary considerably among courts. Cf. In re Pannell, 253 B.R. 216 (S.D. Ohio 2000)("In determining whether a petition was filed for an improper purpose, the bankruptcy court must ask whether the attorney's conduct was reasonable under the circumstances") with Sussman v. Bank of Israel, 56 F.3d 450, 458-59 (2d Cir.1995)(A bankruptcy petition is frivolous under Rule 9011 if it is "patently clear that [it] has absolutely no chance of success"; sanctions based on lack of good faith inquiry or improper purpose must be supported by a threshold finding that the petition is

frivolous). The Second Circuit has counseled that "any and all doubts must be resolved in favor of the signer." Eastway Construction Corp. v. City of New York, 762 F.2d 243 (2d Cir.) cert. denied, 484 U.S. 918 (1987), and that only "where it is patently clear that a claim has absolutely no chance of success under the existing precedents, and where no reasonable argument can be advanced to extend, modify or reverse the law as it stands, Rule 11 has been violated." Id.

C. Malpractice Awards

The unique fiduciary duties held by many courts to apply to estate professionals can lead to malpractice awards based on the breach of such duties. Arguably these kinds of malpractice claims arise from duties beyond those that obtain under the nonbankruptcy law governing ordinary lawyer-client or other professional-client relationships.

Counsel to a debtor in possession can indeed be liable for significant damages – based on malpractice -- for failure to pursue a potential recovery against insiders of a debtor in possession. In re R & R Associates Of Hampton, 402 F.3d 257 (1st Cir. 2005)(counsel to the debtor in possession has broad duties that "include the maximization of the value of the debtor's assets, and the recovery of property for the benefit of the bankruptcy estate," court held that counsel to the debtor in possession was liable for $412,000 shortfall in the estate of a general partnership as a malpractice award to the trustee for the lawyers' failure to diligently pursue the individual partners). See also In re Ogden Modulars, Inc., 207 B.R. 198, 200 (Bankr.E.D.Mo.1997)(Duties of counsel to debtor in possession include the maximization of the value of the debtor's assets, and the recovery of property for the benefit of the bankruptcy estate.)

R & R stands out as an example of significant pre- and postpetition conflicts of interest, in that the defendants in the malpractice case actually represented the general partners of the debtor partnership in shielding their personal assets through transfers to family limited partnerships. But it is instructive to review some of the standards seemingly imposed upon all counsel by the R & R decision. One duty suggested in R & R is an affirmative duty of counsel to a partnership to compel disclosure of the personal financials of the general partners, even to invoke the court through section 1007(g)(which authorizes the court to order any general partner to file a statement of personal assets and liabilities). Id. at 271. Similarly, the court of appeals suggests that counsel was duty-bound to make demand, or actually sue for, contribution by the general partners. Id.

Under this sort of duty, a lawyer for a debtor in possession is essentially forced to act like an independent case trustee, by filing a motion or proceeding that would be vigorously opposed by the same individuals from whom the lawyer takes direction in their roles as the representatives of the debtor in possession. Can a lawyer for a debtor in possession even take such action without client authority?

D. Civil Sanctions under 28 U.S.C. § 1927 and Other Fee-Shifting Statutes

Section 1927 authorizes sanctions, including attorneys' fees, against an attorney "who so multiplies the proceedings in any case unreasonably and vexatiously", provided the case is

in a "court of the United States". There is a split of authority among circuit courts whether a bankruptcy court is included in the statute. The Ninth Circuit does not regard a bankruptcy court as a "court of the United States." 28 U.S.C. § 1927; Perroton v. Gray (In re Perroton), 958 F.2d 889, 896 (9th Cir.1992); Determan v. Sandoval (In re Sandoval), 186 B.R. 490, 495-96 (9th Cir. BAP 1995). The Second and Seventh Circuits do. Matter of Cohoes Indus. Terminal, Inc., 931 F.2d 222 (2d Cir. 1991); In re Volpert, 110 F.3d 494, 500-01 (7th Cir.1997)(Bankruptcy courts have authority to sanction attorneys under 28 U.S.C. § 1927.)

Within the Third Circuit, it appears that section 1927 sanctions may be sought for actions taken in a bankruptcy court. In re Argus Group 1700, Inc. v. Steinman, 1997 WL 87623 (E.D.Pa. 1997). Before imposing section 1927 sanctions, the court must make a factual finding of "willful bad faith on the part of the offending lawyer[.]" Hackman v. Valley, 932 F.2d 239, 242 (3d Cir.1991); see also Ford v. Temple Hosp., 790 F.2d 342, 347 (3d Cir.1986). The Third Circuit Court of Appeals has emphasized that the imposition of sanctions under section 1927 is a discretionary function, and that a court "must balance the equities between the parties" and may "refuse to award attorney's fees even where it finds the existence of bad faith, if, in balancing the equities, it nevertheless determines that an award in a particular case would not serve the interests of justice." Ford, 790 F.2d at 347. "The language of § 1927 limits the court's sanctions power to attorney's actions which multiply the proceedings in the case before the court. Section 1927 does not reach conduct that cannot be construed as part of the proceedings before the court issuing the § 1927 sanctions."

Three other fee-shifting statutes are worth noting. One is section 362(h) of the Bankruptcy Code, which allows sanctions, including attorneys' fees and damages, for willful violations of the automatic stay. Another significant provision is section 330(i)(1), which applies when an involuntary petition is found to have been filed in bad faith, and allows an award of attorneys fees, as well as "damages proximately caused by such filing" and punitive damages. Another fee-shifting statute is 28 U.S.C. § 1447(c), which specifically relates to wrongful removal. This statute gives a court the discretion to grant attorneys' fees and costs for an improper removal. The sanction is applicable to bankruptcy removals, but must be tied to specific removals, by virtue of the language "incurred as a result of the removal." 28 U.S.C. § 1447(c); Billington v. Winograde (In re Hotel Mt. Lassen, Inc.), 207 B.R. 935, 939 (Bankr. E.D. Cal.1997). Finally, in personal cases, a noteworthy section is section 523(d), which provides for fee-shifting awards when a creditor brings a complaint for a determination of nondischargability of a debt, and the complaint is found to have been "not substantially justified". The provision allows an aware of costs and reasonable attorney's fees.

E. Sanctions Based on the Inherent Power of Federal Courts

In addition to statutory authority to award sanctions, federal courts have the inherent power to control the conduct of those who appear before them and punish abuses of the judicial process. Chambers v. Nasco, Inc., 501 U.S. 32, 43-46, 111 S.Ct. 2123, 2131-34 (1991), reh'g denied, 501 U.S. 1269, 112 S.Ct. 12 (awarding attorneys fees against a party). This inherent power is available even if procedural rules exist that would sanction the same conduct. Id. at 49-51, 2135-36.

The inherent power of federal courts to impose sanctions has been extended to bankruptcy courts. Fellheimer, Eichen & Braverman, P.C. v. Charter Technologies, Inc., 57

F.3d 1215, 1224 (3d Cir. 1995); In re Weiss, 111 F.3d 1159, 1172 (4th Cir. 1997); In re Hardee, 165 F.3d 18, 1998 WL 766699 at *3 (4th Cir. 1998); Buck v. HSBC Bank USA, 2004 WL 1811430 at *5 (W.D.N.Y. 2004); In re Ngan Gung Restaurant, 195 B.R. 593, 598 (S.D.N.Y. 1996) (appointing trustee justified under inherent powers to sanction); Pereira v. Felzenberg, 1997 WL 698186 at *5-6 (S.D.N.Y. 1997). There is a split of authority, however, as to whether bad faith or willful misconduct is required in order to award sanctions. 8 Lawrence P. King, Collier on Bankruptcy § 8.06[2][b] (15th ed. rev. 2004).

V. Red Flags of Potential Exposure

There are signs of potential exposure, which if recognized early can allow a professional to lessen the risk of liability or avoid it altogether. Landmines and tripwires are avoidable.

A. From The Perspective of Debtor's Counsel

- Management is having difficulty acting as a fiduciary for creditors
- Directors are not meeting or communicating with Operational management
- Client is not listening, not answering questions directly, or avoiding communication with debtor's counsel
- Client has had multiple counsel prior to counsel's employment
- Client is objecting to counsel's fees
- Client is insisting on taking action when it is clear there is no money
- Post petition vendors aren't being paid
- The lawyer knows that a potential cause of action may exist against an insider of a debtor entity, but it is impractical or impossible for the attorney and management to analyze potential claims and possibly file suit, without special committee, special counsel, or both

B. From The Perspective of Committee's Counsel

- Committee members are bringing counsel to each meeting
- "subcommittees" form and seek to undertake action without formal consideration by a full committee quorum.

C. From The Perspective of The Trustee

- Exceedingly poor records management and files from counsel to the debtor in possession

- Lack of responsiveness from the debtor's professionals

- Unwillingness of counsel to readily agree that the Trustee succeeds to the DIP on the attorney client privilege and other privileges

D. From The Perspective of The Court

- Failure to be candid with the Court

- Excessive continuances and adjournments sought by counsel

- Unprepared counsel

- Failure to attend hearings or bring witnesses

- Failure to give notice of hearings to appropriate parties

- Failure to consult with adverse parties or consult prior to a hearing