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Integrity in Insolvency: Exploring Legal Ethics in Bankruptcy Cases

Recently, ethical issues have brought headlines to several large bankruptcy cases. The problems in Houston relating to the alleged romantic relationship between a Texas bankruptcy judge and an attorney with a Texas-based bankruptcy firm has received widescale publicity. Similarly, the Chapter 11 cases of Rudy Giuliani and Alex Jones have raised questions about the conduct of clients and their lawyers.

This article will not discuss the facts of those cases; there is more than enough literature available for those who are interested. Instead, it is intended to identify key ethical issues for those engaged in the bankruptcy practice. The first and most important principle to understand is that most attorneys have little chance of similar disciplinary action if they adhere to the Model Rules of Professional Conduct, as adopted by their state.

Competence in Bankruptcy Practice

ABA Model Rule of Professional Conduct Rule 1.1[1] requires that a lawyer shall provide competent representation. The obvious import of this section is that counsel must be familiar with the Bankruptcy Code, Bankruptcy Rules and any local rules of the jurisdiction in which a case is filed. Before filing a case or representing a client, it is imperative that a lawyer become familiar with these basic documents as well as any schedules, deadlines, case law, or other relevant practices and precedent which may pertain to the case. By way of example, because the Bankruptcy Code and Rules establish numerous deadlines (e.g. time for filing schedules and statements of affairs, time for filing claims), it is important that these deadlines are recorded in a reminder or calendar system so that none are missed. While this is true in both many litigation and non-litigation matters, the sheer number and unique types of deadlines makes this precaution especially important in bankruptcy cases. As one example, failure to schedule a debt is likely to result in that debt being exempt from the discharge order; accordingly, it is important that the debtor and their counsel be meticulous in completing schedules. As a bankruptcy case impacts all economic aspects of a client's life, it is critical that counsel consider the totality of a client's or its affiliates interests in pursuing a case or a claim.

For example, in a recent Chapter 11 case, counsel was sued for malpractice by the debtor's principals because they claimed that counsel failed to consider the impact that a filing would have on their tax liabilities. The case has not yet been decided but its lesson is clear; counsel must take a broad view of the client's interests in determining what to do when considering a bankruptcy filing.

Conflicts of Interest

Section 327 of the Bankruptcy Code[2] requires that a professional person must be disinterested. "Disinterested person" is defined at Section 101(14)[3] as a person who is not a creditor, equity security holder, or insider, was not within 2 years of the date of filing a director, officer, or employee of the debtor and does not have an interest that is materially adverse to the estate or any class of creditors or equity security holders either directly or indirectly. Note that these restrictions are in addition to the conflict rules that are contained in ABA Model Rules 1.6, 1.7, 1.8, 1.9 and 1.10.

1 ABA Model Rule of Professional Conduct 1.1.

2 11 U.S.C. §327.
3 11 U.S.C. §101(14).

Of particular interest is the requirement that the debtor's counsel not be a creditor. If a client owes counsel money for prior services, the attorney will likely be required to release their claims before they are allowed to serve as debtor's counsel or committee counsel. Counsel should be wary if the debtor has paid past due invoices within the preference period established by Section 547 of the Bankruptcy Code[4] as that may result in both a forfeiture of those payments and a determination that counsel is not disinterested, thus potentially requiring counsel to take additional mitigative steps, including possible retention of conflicts counsel. Attorneys should make certain that all prepetition fees are paid in a timely manner, which may involve obtaining a retainer at the outset, applying it to prepetition fees as they arise, and disclosing the arrangement as part of the first day filings.

Similarly, as in all new engagements, a thorough conflicts check is a must. Here, when representing a debtor with many creditors, the conflicts checks can be quite complex. In some cases where there will be disputes between the debtor and various creditors over the validity of creditors' claims, it may be necessary to retain conflicts' counsel to handle those disputed. Indeed, there exist firms whose principal activity is to serve as conflicts counsel in large bankruptcy cases. Particularly with large complex matters, failure to identify conflicts may result in severe sanctions such as disqualification, disgorgement of fees, rejection of future fees, and disciplinary proceedings.

Due to imputation issues, it is important to make certain that members of counsel's firm do not hold interests that would disqualify the firm. In considering this issue, review ABA Model Rule 1.10(a)(1).

Adequate Disclosure

Perhaps the most sensitive area is the interplay between the Bankruptcy Code's requirements for transparency and full disclosure and the Model Rules' protection of client's confidences. Section 521 of the Bankruptcy Code[5] requires the debtor to file schedules listing all of its creditors, its assets and liabilities, its current income and expenditures and a statement of its financial affairs. In reorganization cases, monthly reports must be filed.

ABA Model Rule 1.6 establishes a lawyer's duty to keep information confidential absent certain narrow exceptions. Specifically, ABA Model Rule 1.6(b)(6) permits disclosure if necessary to comply with other law or court order. While Section 521 mandates that a client-debtor make full and proper disclosure, and is not directly applicable to counsel, the ability to disclose certain information is nonetheless extended to counsel through Model Rule 1.6(b)(6)'s exception. Accordingly, disclosure of specific information required under Section 521[6] is permitted.

Difficulties can arise when the debtor is reluctant to make full disclosure. For example: a debtor who owns a closely-held business who is reluctant to disclose payments made to a family member through their business. Clearly, under ABA Model Rules 3.1 and 3.3, as well as Section 521[7], counsel cannot assist the debtor in failing to acknowledge liabilities, and may not assist the debtor in secreting assets. However, counsel may assist the debtor in challenging a creditor's claim.

This is where pre-filing counseling can save the debtor/client and counsel considerable difficulty. It is imperative that counsel explain to the prospective debtor their obligations and counsel's obligations to comply with the appropriate provisions of the statute and rules. Perhaps actions can be taken to protect assets in advance of a filing. In some cases, a client may choose, after pre-filing counseling, to delay or refrain from filing rather than face the obligations of a debtor. Ultimately, while advising clients prior to a filing, it is important to emphasize the significance of full disclosure. Some clients may wish to conceal assets hoping to keep them out of the reach of creditors. They may want to hide insider payments. If discovered, a debtor may be subject to a denial of discharge. In Chapter 11 cases, this may lead to the appointment of a Trustee or even the conversion of a case to Chapter 7 liquidation. It may also result in a criminal referral. It is particularly important that counsel avoid participating in any such violation.

Duties of Counsel In Certain Capacities

Thus far, this discussion has focused on the duties of debtor's counsel and the ethical issues which may arise from a filing, but counsel for a Trustee and Committee Counsel also may face issues. The issues arising out of the need to be disinterested are similar to the previous discussion. But the additional issue that is common to both positions is that they have duties owed to multiple interests.

Trustee's counsel only owes a direct duty to the Trustee, but the Trustee owes a duty to the creditor body as a whole. Thus in counseling a Trustee, the attorney must keep in mind the Trustee's duty to benefit the estate as a whole and not any particular constituency, including the Trustee. Similarly, committee counsel may face conflicting demands from members of the committee. Here, it is wise to adopt committee by-laws which establish how disputes are to be resolved and enable counsel to engage in joint representation effectively. If counsel is unable to create consensus, the by-laws should allow for the case to proceed. In any event, counsel must remain mindful of ABA Model Rule 1.2 which dictates that the client, not the lawyer, has final say and dictates substantive

4 11 U.S.C. §547.
5 11 U.S.C. §521.
6 *Id.*
7 *Id.*

decisions. Sometimes expert counsel "knows" what the "right" path is in a difficult situation. But if the client cannot be convinced, it is ultimately the client's case and they decide, provided that their decision is ultimately not in contravention to any applicable statute, code, or rule.

Bankruptcy Counsel and Fees

A final topic that is near and dear to attorneys' hearts relates to fees. Counsel for the debtor, trustee, official committee and anyone else seeking fees for a substantial contribution to the case must apply for fees by submitting a fee petition. Individual courts have local rules relating to the form and substance of such petitions, which must be observed. The ethical challenge confronting the attorney is to phrase their fee petition in sufficient detail to allow a court to grant fees but without revealing confidential information that could impair their client's position in the underlying case, or even worse, waive attorney-client privilege. One possible scenario when this might occur involves a lawyer, who, in petitioning the court for fees in a matter, includes a description about the lawyer's discussion with their debtor-client about fraudulent transfer issues, which took place within the two year filing period, prior to the lawyer's retention, and about the fair and reasonable value of a specific house transferred to a family member. Disclosing the information about specific property and its transfer, in this case a house to a specific relative, would clue in opposing parties to actions the debtor has taken relative to specific property and would certainly harm the client while not being necessary for the court to review or grant the fee petition. Rather, a more general description without specific property or transfer information would achieve the same result in the granting of fees without waiving attorney-client privilege or breaching the duty of confidentiality.

While ABA Model Rule 1.6 gives some comfort to attorneys, counsel must take care to provide information required by the rules pertaining to justification of their fee requests without going too far and revealing information that should be kept from the opposition. At base, counsel must provide a sufficient level of detail within the fee petition in order to be successful – ultimately requiring a certain level of disclosure that might otherwise not be required in other litigation contexts. However what qualifies as sufficient may largely depend on the requirements of specific jurisdictions and local court rules, thus highlighting the importance of the specific rules, procedures, and requirements of each court. Remember that fee petitions are public filings subject to examination and challenge by any party in interest. So tension exists between the attorney's desire to reveal sufficient information to get paid and their duty to keep strategic conversations confidential. A degree of judgment is required to navigate this potential problem.

Conclusion

This article has identified the basic ethical principles which govern attorneys' behavior in bankruptcy cases. It is by no means an exhaustive review. Problems can be extremely nuanced. But by keeping in mind these basic principles, particularly with respect to competence, diligence, confidentiality, scope of representation, conflicts of interest, and communication, attorneys in the bankruptcy practice can work to avoid problems, establish strong risk management procedures and ultimately serve their clients' interests successfully.

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