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Ethical Considerations In Insolvency Cases—Beyond Conflicts

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Divergent Interests of Corporation and Its Management

Counsel representing a corporation or other business organization will frequently encounter issues that affect not just the company but also individual directors, officers and managers. A course of action beneficial to the corporate client might create potential liability for some or all of these individuals. For example, a cash-strapped company might withhold payroll taxes, or fail to make provision for timely payment of employee compensation such as accrued vacation or earned commissions, for which responsible managers might ultimately bear personal liability. Or a company might delay paying a corporate credit card co-signed by the employee who holds the card, leaving the employee personally liable. In such situations, managers may feel conflicted between their corporate obligations and their personal interests. It can be a challenge for the company's lawyers to avoid becoming enmeshed in this conflict.

In the course of their interactions with the company's bankruptcy counsel, directors, officers and managers may seek guidance from company counsel concerning individual liabilities. This situation presents a dual hazard to company counsel. First, counsel must not become confused concerning who the client is. Second, counsel must avoid leaving the individuals with the incorrect impression that he is advising the individuals or tailoring his advice to the company to take account of their interests. Counsel's ethical responsibilities can be ascertained with regard to applicable rules of professional conduct, and safeguarded through appropriate disclosures to clients and non-clients along with, in a bankruptcy case, compliance with applicable rules governing retention and disclosure of client relationships.

Divergent Interests Between Creditors' Committee and Its Members

A somewhat similar problem confronts counsel to a creditors' committee when members of the committee hold interests adverse to the committee. For example, a committee member may be alleged to have received a preferential or fraudulent transfer. The member may seek the advice of committee counsel concerning such matter. Once again, counsel's ethical responsibilities can be ascertained through the applicable rules of professional conduct supplemented, in a bankruptcy case, by the provisions of the Bankruptcy Code and rules.

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Pertinent Provisions of ABA Model Rules of Professional Conduct

[Note: The ABA Model Rules of Professional Conduct have been adopted, more or less in their entirety, by each of the New England states within the First Circuit (MA, ME, NH, RI—in Maine, the Rules will be effective August 1, 2009); each state's specific rules of professional conduct should be referred to as appropriate]

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;

(2) the representation is not prohibited by law;

(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

(4) each affected client gives informed consent, confirmed in writing.

Rule 1.9 Duties To Former Clients

(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.

(b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client

(1) whose interests are materially adverse to that person; and

(2) about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(c) that is material to the matter; [*Note: Rule 1.6 governs confidentiality of information*]

unless the former client gives informed consent, confirmed in writing.

(c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:

(1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or

(2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.

Rule 1.13 Organization As Client

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.

(c) Except as provided in paragraph (d), if

(1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization,

then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

(d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an

officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

(e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.

(f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

(g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

Rule 1.18 Duties To Prospective Client

(a) A person who discusses with a lawyer the possibility of forming a client-lawyer relationship with respect to a matter is a prospective client.

(b) Even when no client-lawyer relationship ensues, a lawyer who has had discussions with a prospective client shall not use or reveal information learned in the consultation, except as Rule 1.9 would permit with respect to information of a former client.

(c) A lawyer subject to paragraph (b) shall not represent a client with interests materially adverse to those of a prospective client in the same or a substantially related matter if the lawyer received information from the prospective client that could be significantly harmful to that person in the matter, except as provided in paragraph (d). If a lawyer is disqualified from representation under this paragraph, no lawyer in a firm with which that lawyer is associated may knowingly undertake or continue representation in such a matter, except as provided in paragraph (d).

(d) When the lawyer has received disqualifying information as defined in paragraph (c), representation is permissible if:

(1) both the affected client and the prospective client have given informed consent, confirmed in writing, or:

(2) the lawyer who received the information took reasonable measures to avoid exposure to more disqualifying information than was reasonably necessary to determine whether to represent the prospective client; and

(i) the disqualified lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom; and

(ii) written notice is promptly given to the prospective client.

Rule 2.1 Advisor

In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation.

Rule 2.3 Evaluation For Use By Third Persons

(a) A lawyer may provide an evaluation of a matter affecting a client for the use of someone other than the client if the lawyer reasonably believes that making the evaluation is compatible with other aspects of the lawyer's relationship with the client.

(b) When the lawyer knows or reasonably should know that the evaluation is likely to affect the client's interests materially and adversely, the lawyer shall not provide the evaluation unless the client gives informed consent.

(c) Except as disclosure is authorized in connection with a report of an evaluation, information relating to the evaluation is otherwise protected by Rule 1.6.

Rule 4.1 Truthfulness In Statements To Others

In the course of representing a client a lawyer shall not knowingly:

(a) make a false statement of material fact or law to a third person; or

(b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.

Rule 4.3 Dealing With Unrepresented Person

In dealing on behalf of a client with a person who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding. The lawyer shall not give legal advice to an unrepresented person, other than the advice to secure counsel, if the lawyer knows or reasonably should know that the interests of such a person are or have a reasonable possibility of being in conflict with the interests of the client.

Pertinent Provisions of Bankruptcy Code and Rules of Bankruptcy Procedure

Counsel may not serve as general counsel to a debtor in bankruptcy unless counsel is "disinterested," which requires that counsel not have, or represent any entity that has, an interest materially adverse to the interest of the debtor's estate and creditors. 11 U.S.C. §§ 101(14) and 327(a). This rule applies even where prospective clients with adverse interests might agree to the joint representation. 11 U.S.C. § 327(a); In re Diamond Mortg. Corp. of Illinois, 135 B.R. 78 (Bankr. N.D.Ill.1990) (certain conflicts that client may waive after full disclosure outside of bankruptcy context, such as simultaneous representation of client and client's creditor, are precluded by Bankruptcy Code from being waived). Section 327(e) does permit a debtor to employ, for a specified special purpose, a non-disinterested attorney previously employed by the debtor so long as the attorney does not have an interest adverse to the debtor or the estate with respect to the special matter for which the attorney is employed. However, in order to serve as general bankruptcy counsel to a Chapter 11 debtor, counsel must be distinterested.

Requests by counsel to represent a Chapter 11 debtor as well as related parties have spawned a spectrum of issues. At one end of the spectrum is the issue whether counsel may represent a group of affiliated corporate debtors, all of which are in Chapter 11. This is common practice, usually approved by the bankruptcy court without objection. Even when the affiliated entities hold intercompany claims or potentially divergent interests on specific matters, but otherwise share a common goal of reorganization, courts will generally permit a single firm to represent all affiliated debtors as reorganization counsel, with the potential to address any actual conflicts through retention of special counsel to handle such matters. See, e.g., In re Adelphia Communications Corp., 342 B.R. 122 (S.D.N.Y. 2006) (presence of intercompany claims between Chapter 11 debtors represented by same counsel did not automatically warrant disqualification of counsel; rather, bankruptcy court, in recognition of substantial cost of requiring additional counsel, could adopt wait-and-see, fact-driven approach to determining extent to which disqualification was necessary); but see, In re Interwest Bus. Equip., 23 F.3d 311, 316 (10th Cir.1994) (stating that separate counsel is required where intercompany debts placed each estate in a creditor/debtor relationship with another). At the other end of the spectrum, joint representation of a corporation and its officers, directors or non-corporate affiliate shareholders in a Chapter 11 case is rarely permissible. See, e.g., Parker v. Frazier (In re Freedom Solar Center), 776 F.2d 14, 17 (1st Cir.1985); Roger J. Au & Sons v. Aetna Insurance Co. (In re Roger J. Au), 64 B.R. 600 (N.D. Ohio 1986).

Section 1103(b) of the Bankruptcy Code prohibits an attorney employed to represent an official committee in a Chapter 11 case from representing any other entity having an adverse interest in connection with the case. Counsel's representation of one or more creditors of the same class of creditors represented by the committee is permitted, so long as no actual adverse relationship exists.

Rule 2014 of the Federal Rules of Bankruptcy Procedure requires detailed disclosure of an attorney's relationships with a debtor and other parties in interest as a condition to employment as counsel to the debtor or official committee. Section 329 of the Bankruptcy Code and Fed. R. Bankr. P. 2016 require disclosure concerning compensation paid or arranged for estate professionals. Rule 2019 requires counsel representing multiple creditors to disclose the multiple representations.

Engagement Letter Provisions Addressing Potential Divergent Interests of Corporation and Management

It is advisable when entering into representation of a corporation or other organization to set forth clearly the identity of the client (or clients) and make clear that the client's management or principals, or affiliated entities, are not being represented except as expressly agreed in writing. This disclosure will promote understanding by management that their individual interests are not being represented, and can serve as a touchpoint for future reminders or disclosures in the event potential or actual conflicts arise during the representation, as contemplated by Rules 1.13. and 4.3 of the Model Rules of Professional Conduct. This approach might utilize language such as:

> This firm has been engaged for the sole purpose of representing the Company. Except as [*where client consists of multiple entities:* agreed in this letter and as] we might otherwise agree in writing, this firm has not been engaged to represent any affiliated company or any individual associated with the Company. From time to time, we may advise or represent the Company on matters that also affect directors, officers, managers, employees, stockholders or other affiliates of the Company; however, except as expressly otherwise agreed, our role is solely as counsel for the Company. To the extent that this firm agrees to represent more than one affiliated entity or person, this engagement will not include representing either affiliate against the other on any matters as to which their interests are adverse. However, the existence of differing or even potentially conflicting interests among affiliates will not preclude this firm from representing all of our affiliated clients against non-clients.
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> As you are certainly aware, private communications between an attorney and client are generally protected by the attorney-client privilege, which precludes disclosure of such communications unless the client consents. Our "client" is deemed, under applicable law, to be the Company as an entity, apart from the particular directors and managers now in control. If, for example, a bankruptcy trustee were to be appointed for the Company, he would succeed to the right to exercise or waive the Company's attorney-client privilege.

Representative Caselaw

Matter of Firstmark Corp., 132 F.3d 1179 (7th Cir. 1997)—Bankruptcy rule requiring professional seeking employment by committee to execute verified statement detailing connections with debtor and other parties did not require disgorgement of law firm's fees, beyond $2,250 ordered by district court, as result of inadvertent failure to disclose potential conflict of interest to bankruptcy court, where law firm disclosed to committee, upon discovery, firm's former representation of debtor's former president and firm's current representation of former president in unrelated matter, and immediately discontinued current representation.

In re Bayou Hedge Funds Investment Litigation, 472 F.Supp.2d 528 (S.D.N.Y. 2007)—Discussion of scope of duty, under applicable state law (NY and CT), of counsel to hedge fund to fund's investors and shareholders, in holding that no attorney-client relationship existed between counsel and investors/shareholders that could support investors/shareholders' cause of action for counsel's negligence.

Bagdan v. Beck, 140 F.R.D. 650 (D.N.J.1991)—Attorneys would be disqualified from acting either as special counsel for bankruptcy trustee in pursuing statutory and common-law derivative claims against debtor's directors, or as attorney for individual investors in their claims against directors, based on attorneys' receipt of confidential information both from trustee and investors and their failure to make timely disclosure and secure clients' informed consent to such multiple representation

In re National Liquidators, Inc., 182 B.R. 186 (S.D. Ohio1995)—Absent evidence that estate actually possessed valid recovery claim against member of unsecured creditors committee, bankruptcy court's finding that member was potential preference defendant or fraudulent conveyance defendant did not support finding that member held interest adverse to committee, so as to preclude law firm's dual representation of member and committee; no party alleged existence of possible dispute concerning member's transactions or dealings with committee or estate, or that law firm failed to properly question member about his knowledge of and connection with Chapter 11 debtor and its founder, who was alleged to have raided corporate coffers, misused investor funds, and disappeared leaving debts owed to hundreds of creditors.

In re eToys, Inc., 331 B.R. 176 (Bankr. Del. 2005)—While law firm retained to represent Chapter 11 debtors may not have known, at time of its retention, that one of its other clients had claim against estate, firm's simultaneous representation of debtors and, in an unrelated matter, another client who held a claim against debtors constituted "actual conflict of interest" that should have been disclosed in bankruptcy case; because failure to disclose was inadvertent and not willful, court-ordered disgorgement of fees limited to those earned in representation of non-debtor client. As stated by the eToys court:

> Disclosure "goes to the heart of the integrity of the bankruptcy system." [In re B.E.S. Concrete Products, Inc., 93 B.R. 228, 236 (Bankr. E.D. Cal. 1988).] Therefore, the duty to disclose under Bankruptcy Rule 2014 is considered sacrosanct because the complete and candid disclosure by an attorney seeking employment is indispensable to the court's discharge of its duty to assure the attorney's eligibility for employment under section

> 327(a) and to make an informed decision on whether the engagement is in the best interest of the estate. See, e.g., In re Leslie Fay Cos., 175 B.R. 525, 533 (Bankr.S.D.N.Y.1994). See generally 9 Collier on Bankruptcy ¶ 2014.03 (15th ed. 2004). The bankruptcy court must be given timely and complete disclosure by the debtor's attorney of all connections with parties in interest in the case to "exercise its own ongoing affirmative responsibility 'to root out impermissible conflicts of interest' under Bankruptcy Code §§ 327(a) and 328(c)." Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir. 1994). See also, In re BH & P, Inc., 949 F.2d 1300, 1315 (3d Cir.1991).

331 B.R. at 189, 190.

In re Best Craft General Contractor and Design Cabinet, Inc., 239 B.R. 462 (Bankr. E.D.N.Y. 1999)— Law firm that represented creditor in state court action against Chapter 7 debtor and its principals was not disqualified, based on its alleged lack of disinterestedness, from acting as special counsel to trustee for purpose of pursuing fraudulent conveyance claims against debtor's principals, where law firm and creditor had effectively subordinated their individual claims to any potential monies recovered from debtor's principals, firm was employed by trustee only for narrow purpose of pursuing fraudulent conveyance claims, and trustee and creditor had parallel interest of maximizing estate through recovery on these fraudulent conveyance claims.

In re Rabex Amuru of North Carolina, Inc., 198 B.R. 892 (Bankr. M.D.N.C. 1996)—Law firm retained to represent involuntary Chapter 11 debtor was not "disinterested," and had to be removed as debtor's counsel, where firm's fees were paid by petitioning creditor holding second largest unsecured claim against bankruptcy estate and also involved in dispute over ownership and control of debtor; firm's continued receipt of its fee from party who, as petitioning creditor, was aligned adversely to debtor's interests gave rise to appearance of conflict sufficient to require firm's disqualification

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