2021 Seventh Circuit ACB Program

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Ethics: a little bit of this and a little bit of that

- ***Candor Toward the Tribunal;***
- ***Ex Parte communications and Rule 9003;***
- ***Conflicts of interest: representing related parties, conflict counsel and disinterestedness***

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The Duty of Candor to the Tribunal v. The Duty of Confidentiality to Your Client

2021 Seventh Circuit ACB Program

By: Honorable Mary Jo Heston

United States Bankruptcy Judge, W.D. Wash.

The Duty of Candor to the Tribunal v. The Duty of Confidentiality to Your Client

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1. Introduction

   a. The following materials are for our discussion of the tension between a lawyer's duty of candor to the tribunal under Model Rule of Professional Conduct ("MRPC") 3.3 and her potentially conflicting duty of confidentiality to her client under MRPC 1.6. This discussion involves real-world bankruptcy hypotheticals involving client misstatements, omissions, and lies. Attached in the Appendix are relevant rules and statutes that you will need for our discussion. Here is a list of Appendix sources:

      i. MRPC 3.3: Candor Toward the Tribunal.
      ii. Selected Comments on MRPC 3.3.
      iii. MRPC 1.6: Confidentiality of Information.
      iv. Selected Comments on MRPC 1.6.
      v. 18 U.S.C. § 152 - Concealment of assets; false oaths and claims; bribery.
      vi. 18 U.S.C. § 157 - Bankruptcy fraud.
      vii. Federal Rule of Civil Procedure ("FRCP") 30(e) - Review by the Witness; Changes.

2. General Standards for Candor to the Tribunal

   a. A lawyer shall not knowingly make a false statement of fact or law to a court or fail to correct a false statement of material fact or law she made to a court.[1] A lawyer shall not knowingly offer evidence that the lawyer knows to be false.[2] If a lawyer, the lawyer's client, or a lawyer's witness offers material evidence and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the court.[3]

   b. MRPC 3.3 governs lawyer conduct when representing a client before a court.[4] It also applies to lawyer conduct when representing a client in an ancillary proceeding like a

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[1] MRPC 3.3: Candor Toward the Tribunal, https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_3_3_candor_toward_the_tribunal/.
[2] *See* MRPC 3.3.
[3] *See* MRPC 3.3.
[4] *See* MRPC 3.3 Comment [1].

deposition.[5] For example, a lawyer must take remedial measures if the lawyer comes to know that a testifying client in a deposition has offered false evidence.[6]

c. MRPC 3.3 explains lawyers' special duties as officers of the court to avoid conduct that undermines the adjudicative process' integrity.[7] A lawyer before a court is obligated to present the client's case with persuasive force.[8] Performing such duty while maintaining client confidences is qualified by the lawyer's duty of candor to the court.[9]

3. General Standards for Client Confidentiality

a. A lawyer shall not reveal information relating to client representation unless the client gives informed consent, the disclosure is impliedly authorized to carry out the representation, or the disclosure is permitted by the ethics rules.[10] A lawyer may reveal information relating to client representation if the lawyer reasonably believes it necessary to, among other things, 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.[11] A lawyer must reasonably prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the client representation.[12]

b. This Rule governs a lawyer's disclosure of information relating to client representation during such client representation.[13] A fundamental principle in the client-lawyer relationship is that, in the absence of the client's informed consent, the lawyer must not reveal information relating to the representation.[14] There are limited exceptions to the rule of confidentiality where a lawyer may reveal information if necessary to enable affected persons or appropriate authorities to prevent the client

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[5] *See* MRPC 3.3 Comment [1].
[6] *See* MRPC 3.3 Comment [1].
[7] *See* MRPC 3.3 Comment [2].
[8] *See* MRPC 3.3 Comment [2].
[9] *See* MRPC 3.3 Comment [2].
[10] MRPC 1.6: Confidentiality of Information, https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_6_confidentiality_of_information/.
[11] *See* MRPC 1.6.
[12] *See* MRPC 1.6.
[13] *See* MRPC 1.6 Comment [1].
[14] *See* MRPC 1.6 Comment [2].

from committing a crime or fraud.[15] Such a serious abuse of the client-lawyer relationship by the client forfeits the protection of MRPC 1.6.[16]

4. When the Duty of Candor and Confidentiality Conflict

   a. Generally, MRPCs 1.6 and 3.3 state that a lawyer has a duty of candor to the tribunal as an officer of the court but also a duty of confidentiality where "[a] lawyer shall not reveal information relating to the representation of a client" absent informed consent. These maxims may become adverse to each other when a lawyer's client is dishonest, is committing fraud, or is committing other criminal conduct.

   b. In some circumstances, a lawyer's duty of candor may supersede the lawyer's duty of confidentiality to the client. Such circumstances involve preventing a crime or fraud that is *reasonably* certain to substantially injure another's financial interests or property.[17] Textbook examples are a lawyer ensuring a client does not conceal assets in bankruptcy schedules or knowingly making a false statement of material fact or law because conduct otherwise is a federal crime. *See* 18 U.S.C. §§ 152 (Concealment of assets; false oaths and claims; bribery), 157 (Bankruptcy fraud). Also, the continuing concealment of property post-discovery is a federal crime.[18] For fraud, a lawyer needs to reveal *only* as much as necessary to remedy the harm—nothing more.[19]

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[15] *See* MRPC 1.6 Comment [7].
[16] *See* MRPC 1.6 Comment [7].
[17] *See* MRPC 1.6(b)(2)–(3).
[18] *See United States v. Arge*, 418 F.2d 721 (10th Cir. 1969) (holding that concealment of assets is a continuing offense); *Burchinal v. United States*, 342 F.2d 982, 985 (10th Cir.), *cert. denied*, 382 U.S. 843 (Oct. 11, 1965) ("It is sufficient to constitute concealment if it prevents the discovery of or withholds knowledge of the asset."); *United States v. Arge*, 418 F.2d 721, 724 (10th Cir. 1969); *United Stated v. Shapiro*, 101 F.2d 375 (7th Cir. 1939), *cert. denied*, 306 U.S. 657 (April 3, 1939) (failing to account for assets pre-bankruptcy on the schedules may constitute offense of concealing assets from a trustee if there is continued concealment postpetition with criminal intent).
[19] Also, importantly, there is no attorney client privilege for fraud. *In re Grand Jury Investigation*, 810 F.3d 1110, 1113 (9th Cir. 2016) ("Under the crime-fraud exception, communications are not privileged when the client 'consults an attorney for advice that will serve him in the commission of a fraud' or crime."); *see* MRPCs 1.6(b)(2)–(3), 3.3(b).

5. The Importance of Client Counseling to Prevent Disclosure of Information

   a. When a client might be or is lying, a lawyer should first counsel the client to be honest, forthcoming, and to immediately remedy any potential knowing or unintentional misrepresentation in bankruptcy proceedings. *See In re Ward*, 894 F.2d 771 (5th Cir. 1990) (requiring an attorney disclose any concealed assets and management's possible criminal activity that the attorney knew may have occurred); *In re Count Liberty, L.L.C.*, 370 B.R. 259, 281 (Bankr. C.D. Cal. 2007); *see In re Wilde Horse Enters., Inc.*, 136 B.R. 830, 847 (Bankr. C.D. Cal. 1991) (stating where an attorney suspects debtor dishonesty, "it is the attorneys' duty to first ask probing questions and demand full and reasonably corroborated responses, and then if counsel is still unsatisfied or ethically uncomfortable, immediately bring the unresolved concerns to the Court's attention by way of a motion to be relieved as counsel of record or in some other way").

   b. If initial counseling does not lead to remedying the improper conduct, what do you do? Disclose the information to the tribunal? Seek a *Noisy Withdrawal*?[20] Continue representing the client? It depends and the answer is not always clear.

      i. MRPC 3.3's Comment [10] addressing remedial measures offers further guidance:

> [10] Having offered material evidence in the belief that it was true, a lawyer may subsequently come to know that the evidence is false. Or, a lawyer may be surprised when the lawyer's client, or another witness called by the lawyer,

[20] C.R. Bowles, Jr., *Noisy Withdrawals: Urban Bankruptcy Legend or Invaluable Ethical Tool?*, AM. BANKR. INST. J., Oct. 2001, https://www.abi.org/abi-journal/noisy-withdrawals-urban-bankruptcy-legend-or-invaluable-ethical-tool (defining "Noisy Withdrawal" in the context of DIP representation, among other circumstances, to be ethically notifying the court when the DIP is being dishonest or fraudulent and suggesting three things an attorney should include in a pleading to effectively withdraw: "First, upon discovery of the fraud and the failure of the attorney to have the DIP rectify and/or disclose the fraud, counsel should move on an expedited basis to be permitted to withdraw as counsel for the estate . . . [Second,] set forth, as your primary grounds for withdrawal, that continued representation is impossible under your applicable state rules of ethics . . . [Third,] if necessary under the circumstances of your case, in your motion to withdraw you may also have to disavow any pleadings based on your client's fraud or on false evidence.").

> offers testimony the lawyer knows to be false, either during the lawyer's direct examination or in response to cross-examination by the opposing lawyer. In such situations or if the lawyer knows of the falsity of testimony elicited from the client during a deposition, the lawyer must take reasonable remedial measures. In such situations, the advocate's proper course is to remonstrate with the client confidentially, advise the client of the lawyer's duty of candor to the tribunal and seek the client's cooperation with respect to the withdrawal or correction of the false statements or evidence. If that fails, the advocate must take further remedial action. If withdrawal from the representation is not permitted or will not undo the effect of the false evidence, the advocate must make such disclosure to the tribunal as is reasonably necessary to remedy the situation, even if doing so requires the lawyer to reveal information that otherwise would be protected by Rule 1.6. It is for the tribunal then to determine what should be done — making a statement about the matter to the trier of fact, ordering a mistrial or perhaps nothing.
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> MRPC Comment [10].

6. For a more thorough general discussion of related issues, among others, read the following detailed compilation: Kaaran E. Thomas, *et al.*, *Navigating through the Ethical Maze of Fiduciary Duties: Ratting on Clients and Other Hazards*, AMERICAN BANKRUPTCY INSTITUTE: VALCON 2011 Volatility, Valuations and Restructurings (February 23, 2011).
7. Hypotheticals for Discussion
    a. The following three real-world hypotheticals highlight key discussion points in the occasionally dueling duties between the duty of candor and confidentially.
        i. Considering the requirement to certify deposition testimony under FRCP 30(f), you and your client are at a deposition and your client lies in testimony.

What do you do?[21] Note, your course of action may depend on whether your discovery the falsehood before or after the deposition testimony is certified.

ii. Shortly after filing a Chapter 11 case with schedules and during DIP financing negotiations with the prepetition lender, you learn that your client had a bank account where some receivables were deposited pre-bankruptcy and that bank account was not disclosed on the filed schedules. What do you do?

iii. You learn from your client's internal accountant that despite sternly counseling your client about the need to tell the truth and the penalties of not doing so, that there is suddenly more agricultural product available than the harvest records reflect for the weight of products removed from the field. What do you do?

[21] Under FRCP 30(e), one potential option to address both form and substance of a deponent's certified testimony is requesting to make changes before the deposition is complete and within thirty days of the deposition officer providing notice that the transcript or recording is available. *See* FRCP 30(e). "If [a][p]laintiff wish[es] to contradict h[is] own deposition testimony, the permissible procedural method [is] .... to either (1) clarify h[is] testimony on cross-examination ... pursuant to Fed. R. Civ. P. 30(c)(1), or (2) within 30 days after the deposition transcript becomes available, sign a statement listing the changes to that transcript, and the reasons for making those changes, pursuant to Fed. R. Civ. P. 30(e)(1)(B)." *Felix-Torres v. Graham*, 687 F. Supp. 2d 38, 50 (N.D.N.Y. 2009).

APPENDIX

MRPC 3.3: Candor Toward the Tribunal,
https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_3_3_candor_toward_the_tribunal/.

a) A lawyer shall not knowingly:

(1) make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer;

(2) fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel; or

(3) offer evidence that the lawyer knows to be false. If a lawyer, the lawyer's client, or a witness called by the lawyer, has offered material evidence and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal. A lawyer may refuse to offer evidence, other than the testimony of a defendant in a criminal matter, that the lawyer reasonably believes is false.

(b) A lawyer who represents a client in an adjudicative proceeding and who knows that a person intends to engage, is engaging or has engaged in criminal or fraudulent conduct related to the proceeding shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal.

(c) The duties stated in paragraphs (a) and (b) continue to the conclusion of the proceeding, and apply even if compliance requires disclosure of information otherwise protected by Rule 1.6.

(d) In an ex parte proceeding, a lawyer shall inform the tribunal of all material facts known to the lawyer that will enable the tribunal to make an informed decision, whether or not the facts are adverse.

Selected Comments from MRPC 3.3,
https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_3_3_candor_toward_the_tribunal/comment_on_rule_3_3/.

[1] This Rule governs the conduct of a lawyer who is representing a client in the proceedings of a tribunal. See Rule 1.0(m) for the definition of "tribunal." It also applies when the lawyer is representing a client in an ancillary proceeding conducted pursuant to the tribunal's adjudicative authority, such as a deposition. Thus, for example, paragraph (a)(3) requires a lawyer to take reasonable remedial measures if the lawyer comes to know that a client who is testifying in a deposition has offered evidence that is false.

[2] This Rule sets forth the special duties of lawyers as officers of the court to avoid conduct that undermines the integrity of the adjudicative process. A lawyer acting as an advocate in an adjudicative proceeding has an obligation to present the client's case with persuasive force. Performance of that duty while maintaining confidences of the client, however, is qualified by the advocate's duty of candor to the tribunal. Consequently, although a lawyer in an adversary proceeding is not required to present an impartial exposition of the law or to vouch for the evidence submitted in a cause, the lawyer must not allow the tribunal to be misled by false statements of law or fact or evidence that the lawyer knows to be false.

. . .

Remedial Measure

[10] Having offered material evidence in the belief that it was true, a lawyer may subsequently come to know that the evidence is false. Or, a lawyer may be surprised when the lawyer's client, or another witness called by the lawyer, offers testimony

the lawyer knows to be false, either during the lawyer's direct examination or in response to cross-examination by the opposing lawyer. In such situations or if the lawyer knows of the falsity of testimony elicited from the client during a deposition, the lawyer must take reasonable remedial measures. In such situations, the advocate's proper course is to remonstrate with the client confidentially, advise the client of the lawyer's duty of candor to the tribunal and seek the client's cooperation with respect to the withdrawal or correction of the false statements or evidence. If that fails, the advocate must take further remedial action. If withdrawal from the representation is not permitted or will not undo the effect of the false evidence, the advocate must make such disclosure to the tribunal as is reasonably necessary to remedy the situation, even if doing so requires the lawyer to reveal information that otherwise would be protected by Rule 1.6. It is for the tribunal then to determine what should be done — making a statement about the matter to the trier of fact, ordering a mistrial or perhaps nothing.

MRPC 1.6: Confidentiality of Information,
https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/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;

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

(7) to detect and resolve conflicts of interest arising from the lawyer's change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client.

(c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.

Selected Comment from MRPC 1.6,
https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_6_confidentiality_of_information/comment_on_rule_1_6/.

[2] A fundamental principle in the client-lawyer relationship is that, in the absence of the client's informed consent, the lawyer must not reveal information relating to the representation. See Rule 1.0(e) for the definition of informed consent. This contributes to the trust that is the hallmark of the client-lawyer relationship. The client is thereby encouraged to seek legal assistance and to

communicate fully and frankly with the lawyer even as to embarrassing or legally damaging subject matter. The lawyer needs this information to represent the client effectively and, if necessary, to advise the client to refrain from wrongful conduct. Almost without exception, clients come to lawyers in order to determine their rights and what is, in the complex of laws and regulations, deemed to be legal and correct. Based upon experience, lawyers know that almost all clients follow the advice given, and the law is upheld.

[7] Paragraph (b)(2) is a limited exception to the rule of confidentiality that permits the lawyer to reveal information to the extent necessary to enable affected persons or appropriate authorities to prevent the client from committing a crime or fraud, as defined in Rule 1.0(d), that is reasonably certain to result in substantial injury to the financial or property interests of another and in furtherance of which the client has used or is using the lawyer's services. Such a serious abuse of the client-lawyer relationship by the client forfeits the protection of this Rule. The client can, of course, prevent such disclosure by refraining from the wrongful conduct. Although paragraph (b)(2) does not require the lawyer to reveal the client's misconduct, the lawyer may not counsel or assist the client in conduct the lawyer knows is criminal or fraudulent. See Rule 1.2(d). See also Rule 1.16 with respect to the lawyer's obligation or right to withdraw from the representation of the client in such circumstances, and Rule 1.13(c), which permits the lawyer, where the client is an organization, to reveal information relating to the representation in limited circumstances.

18 U.S. Code § 152 - Concealment of assets; false oaths and claims; bribery.

A person who—

(1) knowingly and fraudulently conceals from a custodian, trustee, marshal, or other officer of the court charged with the control or custody of property, or, in connection with a case under title 11, from creditors or the United States Trustee, any property belonging to the estate of a debtor;

(2) knowingly and fraudulently makes a false oath or account in or in relation to any case under title 11;

(3) knowingly and fraudulently makes a false declaration, certificate, verification, or statement under penalty of perjury as permitted under section 1746 of title 28, in or in relation to any case under title 11;

(4) knowingly and fraudulently presents any false claim for proof against the estate of a debtor, or uses any such claim in any case under title 11, in a personal capacity or as or through an agent, proxy, or attorney;

(5) knowingly and fraudulently receives any material amount of property from a debtor after the filing of a case under title 11, with intent to defeat the provisions of title 11;

(6) knowingly and fraudulently gives, offers, receives, or attempts to obtain any money or property, remuneration, compensation, reward, advantage, or promise thereof for acting or forbearing to act in any case under title 11;

(7) in a personal capacity or as an agent or officer of any person or corporation, in contemplation of a case under title 11 by or against the person or any other person or corporation, or with intent to defeat the provisions of title 11, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation;

(8) after the filing of a case under title 11 or in contemplation thereof, knowingly and fraudulently conceals, destroys, mutilates, falsifies, or makes a false entry in any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor; or

(9) after the filing of a case under title 11, knowingly and fraudulently withholds from a custodian, trustee, marshal, or other officer of the court or a United States Trustee entitled to its possession, any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor, shall be fined under this title, imprisoned not more than 5 years, or both.

18 U.S.C. § 157 - Bankruptcy fraud.

A person who, having devised or intending to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice or attempting to do so—

(1) files a petition under title 11, including a fraudulent involuntary petition under section 303 of such title;

(2) files a document in a proceeding under title 11; or

(3) makes a false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under title 11, at any time before or after the filing of the petition, or in relation to a proceeding falsely asserted to be pending under such title, shall be fined under this title, imprisoned not more than 5 years, or both.

Federal Rule of Civil Procedure 30(e) - Review by the Witness; Changes.

(e) Review by the Witness; Changes.

(1) *Review; Statement of Changes.* On request by the deponent or a party before the deposition is completed, the deponent must be allowed 30 days after being notified by the officer that the transcript or recording is available in which:

(A) to review the transcript or recording; and

(B) if there are changes in form or substance, to sign a statement listing the changes and the reasons for making them.

(2) *Changes Indicated in the Officer's Certificate.* The officer must note in the certificate prescribed by Rule 30(f)(1) whether a review was requested and, if so, must attach any changes the deponent makes during the 30-day period.

Skadden

KIRKLAND & ELLIS

Conflicts of Interest

And the Use of Conflicts Counsel

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1 Conflicts of Interests in Modern Practice

Conflicts of Interest Inherent in Modern Practice

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- As the global bankruptcy practice has grown larger, navigating the ethical obligations and responsibilities of bankruptcy advisors has become increasingly complex.
- Because major bankruptcy cases involve large multinational corporations, they require the services of multidisciplinary law firms.
  - The scope and scale of modern bankruptcy filings makes it nearly impossible for parties to find counsel that are entirely without connections to any adverse party.
  - Disqualifying a firm from its involvement in these cases due to its connections with a stakeholder is impractical.
- Where appropriate, conflicts counsel can help firms resolve some of these issues.

The Ethical Obligations of Lawyers

Model Rules of Professional Conduct

KIRKLAND & ELLIS Skadden

- A law firm must satisfy its state's own ethical rules as well as additional restrictions in the United States Bankruptcy Code.
- Model Rule of Professional Conduct 1.7 provides that a lawyer shall not represent a client if:
  - (a) 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.

The Ethical Obligations of Lawyers
11 U.S.C. § 327(a)

- As a general rule, 11 U.S.C. § 327(a) permits debtors in possession (DIP) to employ attorneys, accountants, and other professionals, provided that they:
  - Do not hold or represent an interest adverse to the estate; and
  - Are disinterested persons.
- Section 1107(b) permits professional that have worked for the debtor prior to the commencement of the case to be eligible for post-petition retention in the event that they satisfy the requirements of § 327(a).
- However, § 327(c) provides an exception to the § 327(a) requirements:
  - Employment by a creditor is not a disqualification, unless there is an objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.

What Does § 327(a) Prohibit?

- **What is an "Adverse Interest"?**
  - No clear definition in the Bankruptcy Code
  - Case law suggests that an adverse interest may exist where the professional:
    - "Possessing or asserting any economic interest that would lessen the value of the bankruptcy estate or would create an actual or potential dispute with the estate as a rival claimant; or [] possesses a predisposition under circumstances that render such a bias against the estate." *Maiman v. Spizz*, 554 B.R. 604, 617 (S.D.N.Y. 2016), citing *In re AroChem Corp.*, 176 F.3d 610, 623 (2d Cir. 1999).
    - *See In re Granite Partners, L.P.*, 219 B.R. 22, 33 (Bankr. S.D.N.Y. 1998) ("[T]he professional has a disabling conflict if it has either a meaningful incentive to act contrary to the best interests of the estate and its sundry creditors—an incentive sufficient to place those parties at more than acceptable risk—or the reasonable perception of one." (internal citation and quotation marks omitted)).
    - Section 327 ensures that all professionals appointed by the court meet their fiduciary responsibilities.

The “Disinterested” Requirement

- **Who is a “Disinterested Person”?**
  - 11 U.S.C. § 101(14) defines a “disinterested person” as one who:
    - (A) Is not a creditor, an equity security holder, or an insider;
    - (B) Is not and was not, within two years before the date of the filing of the petition, a director, officer or employee of the debtor; and
    - (C) Does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.

Violating § 327 Can Result in the Denial of Fees

- Section 328(c) permits courts to deny fees to a professional retained under Section 327 if that professional is found anytime during their retention to:
  - "not [be] a disinterested person" or
  - "represent or hold an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed"
- This section creates an on-going duty to check conflicts and to ensure that a retained professional is disinterested
- *See NNN 400 Cap. Ctr. 16, LLC*, 619 B.R. 802, 816 (Bankr. D. Del. 2020) (disqualifying a firm and requiring disgorgement of fees paid in connection with the firm's representation of debtors when the firm failed to disclose the existence of a pre-petition fee sharing agreement as required by Rule 2014 and 11 U.S.C. § 327(e)).

Bankruptcy Rule 2014 Requires Disclosure of All Connections

- Rule 2014 requires disclosure of a professional's connections with:
  - The debtor
  - Any creditors
  - Other parties in interest
  - The attorneys and accountants of the debtors, creditors, and other parties in interest
  - The U.S. Trustee and persons employed by the U.S. Trustee's office
- Disclosures must be detailed enough to permit the court to determine whether professionals have satisfied § 327(a). *In re Renaissance Residential of Countryside, LLC*, 423 B.R. 848, 857 (Bankr. N.D. Ill. 2010).
- An applicant must disclose all connections, regardless of whether they rise to the level of a disqualifying interest under § 327(a).

2 Conflicts Counsel as a Potential Solution

Conflicts Counsel Can Prevent Firms from Disqualification

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- Courts try to balance twin goals of giving the debtor an opportunity to reorganize and honor ethical rules.
- To ease this balance, Chapter 11 debtors have proposed, and courts have approved, the appointment of a second law firm as conflicts counsel, to undertake the representation of the Chapter 11 debtors on matters where § 327(a) counsel has pre-existing connections that may lead to the appearance of an "adverse interest."
- **The U.S. Trustee and numerous courts have recognized the utility in retaining conflicts counsel.**
  - The U.S. Trustee has issued guidelines that state that: "[c]onflicts counsel is secondary counsel [that is] employed when lead bankruptcy counsel is subject to a limited, not pervasive, conflict of interest that prevents it from performing some small part of its duties." "Guidelines for Reviewing Applications for Compensation and Reimbursement of Expenses Filed under United States Code by Attorneys in Larger Chapter 11 Cases," 78 *Fed. Reg*. 36248, 36256 (June 17, 2013).
  - *See, e.g., In re Boy Scouts of Am.*, 2021 WL 1820574 (D. Del. May 6, 2021) (recognizing the effectiveness of the retention of discrete matters for which debtor's counsel would otherwise be disqualified under § 327(a)); *see also In re Project Orange Assocs., LLC*, 431 B.R. 363, 375 (Bankr. S.D.N.Y 2010) (stating that "[i]n many cases, the employment of conflicts counsel to handle issues where general bankruptcy counsel has an adverse interest solves most questions regarding the retention of general bankruptcy counsel.")

Which Connections Can Conflicts Counsel Help Solve?

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- Conflicts counsel can solve issues with pre-existing connections that, among other things:
  - (1) are unlikely to occur throughout the case;
  - (2) involve just a few parties in interest;
  - (3) do not involve the main issues in the case; and
  - (4) are capable of being handed over to a non-conflicted law firm.

The Use of Conflicts Counsel in Business Reorganization Cases, 37, 41 (2013), https://abi-org.s3.amazonaws.com/Endowment/Research_Grants/Final_Report_ABI_Ethics_Task_Force.pdf.

When is the Retention of Conflicts Counsel Inappropriate?

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- The retention of conflicts counsel is inappropriate where such retention cannot resolve a § 327(a) counsel's disqualifying connections.
- Conflicts counsel should not be used to handle matters that are inseparable from the major reorganization activities of the case, such as the negotiation of major plan provisions.
- The National Ethics Task Force recommends that "the best design for conflicts counsel involves separate spheres of issues, with only minimal overlap for coordination and communication purposes."

Adopted from The Final Report of the American Bankruptcy Institute

Seeking Approval of Conflicts Counsel

- To obtain approval for the retention of conflicts counsel, counsel should provide Rule 2014 disclosures to address the following components, among other things:
  - the need for the appointment of conflicts counsel;
  - the nature of the potential issues conflicts counsel would resolve;
  - the anticipated extent of the conflicts with respect to the case generally;
  - subject to ethical obligations, the identities of the § 327(a) counsel's connection that relate to the Chapter 11 debtors;
  - subject to ethical obligations, any discussions regarding any waivers of potential or actual conflicts;
  - additional disclosures that may be necessary to provide the court with sufficient information to determine whether the approval of conflicts counsel is appropriate.
- Main counsel should seek early appointment of conflicts counsel. *See e.g. In re J&M Dev. Of Cass County*, No. 04-41065, 2004 WL 1146451, *3 (Bankr. W.D. Mo. 2004) citing *In re BH&P, Inc.*, 103 B.R. 556 (Bankr. N.J. 1989) (holding that problems associated with conflicts can be avoided if conflicts counsel is employed from the "outset").

The Use of Conflicts Counsel in Business Reorganization Cases, 37, 41 (2013), https://abi-org.s3.amazonaws.com/Endowment/Research_Grants/Final_Report_ABI_Ethics_Task_Force.pdf.

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