Research Paper 10-16
February 2, 2010

Debtor Counsel's Fiduciary Duty: Is There a Duty to Rat in Chapter 11?

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American Bankruptcy Institute Journal, Feb. 2010, at 16

AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
Issues and Information for Today's Busy Insolvency Professional

Debtor Counsel's Fiduciary Duty: Is There a Duty to Rat in Chapter 11?

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This installment of Straight & Narrow takes a different form, as it is a counterpart to **Alec Ostrow**'s excellent 2008 article[1] in the *ABI Law Review* concerning the extent of the duties of a chapter 11 debtor's counsel (DIP counsel) to a chapter 11 bankruptcy estate and its management.[2]

If a Lawyer Has the Estate for a Client, Does the Client Have a Fool for a Lawyer?

C.R. "Chip" Bowles, Jr.

Bankruptcy is not like the rest of the legal world, in which the name of the client can give the lawyer a real understanding about whom she represents. It's too facile to say that DIP counsel only represents the DIP and, therefore, she only owes a fiduciary duty to the DIP—because the DIP itself is a fiduciary for the bankruptcy estate. It's also precious little guidance to say (although we have) that DIP counsel is estate counsel, unless we also spell out what that means.

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What does it mean to represent the estate? It is literally true that DIP counsel does not represent all of the various constituencies with an interest in the outcome of the case. For example, DIP counsel must have a separate role from that of counsel for the creditors' committee, because those two entities can often have interests that conflict. Creditors' committee counsel represents the unsecured creditors as a group and must take those interests into account when advising the creditors' committee. The same principle holds true for other constituencies interested in distributions from the estate, and thankfully it is not true that DIP counsel owes a duty to individual creditors (or, for that matter, individual equity securityholders).[3]

Although the constituents with a claim on estate assets—secured creditors, unsecured creditors and owners when there are sufficient assets left over—have representation already, it is not quite true to say that DIP counsel can take its marching orders from the DIP without consideration of the fiduciary needs *of the estate itself*. There is a theory missing here, and that is why there has been some real discomfort in trying to spell out exactly what DIP counsel's responsibilities are. No normal theories really fit, which is why questions like whether DIP counsel has a duty to rat on a misbehaving DIP are so confounding.

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Part of the reason that DIP counsel owes something to the estate is that the estate's funds (read: money coming from the pockets of the unsecured creditors) are paying her fees and expenses. Do not get us wrong: There is an ethics rule in place that clearly states that the person who pays the bill, if that person is not the client, does not get to call the shots in the case.[4] Here, though, the estate is the *raison d'etre* of the reorganization: maximizing it, restructuring it and coming out successfully on the other side of chapter 11. The DIP is charged with the rights, powers and duties of a trustee in chapter 11 under 11 U.S.C. §1107. Of course, that statement just puts us back right where we started, in an infinite loop: The DIP itself is a fiduciary for the estate as a whole.

In a sense, being counsel for the DIP is a lot like being counsel for a corporation: Counsel takes its marching orders from management (the bankruptcy analogy would be the DIP) but is beholden to the ultimate

1 Ostrow, "We Don't Need the Case Law to Turn the DIP's Attorney into a Court Informant," 27 *ABI L. J.* 14 (May 2008).

2 For purposes of this article, "management" will also include an individual chapter 11 debtor who is acting as a debtor-in-possession in his or her chapter 11 case. For a discussion of the particular problems of DIP counsel's duties concerning an individual chapter 11 debtor, *see* Bowles, Schaaf and Stosberg, "Ghosts of Individual Chapter 11 Debtors (Parts I and II)," 25 *ABI L. J.* 46 (December/January 2007) & 26 *ABI L. J.* 36 (February 2007).

3 *See ICM Notes Ltd. V. Andrews & Kurth LLP*, 278 B.R. 117 (S.D. Tex. 2002), *aff'd, In re ICM Notes Ltd.*, 324 F.3d 768 (5th Cir. 2003) (holding that DIP counsel does not hold fiduciary duty to specific creditors).

4 MRPC 1.8(f), www.abanet.org/cpr/mrpc/rule_1_8.html.

owners (for a corporation, the shareholders; for the DIP, the "owners" to whom the DIP owes allegiance is the estate—those "owning" the estate during the case and the owners eventually emerging on the other side of a successful reorganization).[5] In "normal" (nonbankruptcy) cases, the ethics rules recognize the tensions inherent in representing an entity, providing an understanding of the difference between direction (marching orders) and role (allegiance to shareholders) in the rule that provides for "up the chain" reporting when representing an organization as the client.[6] Being counsel for the DIP is different from being counsel for the corporation though because DIP counsel's behavior as an officer of the court is a significant component of the representation as well.

In part because the chapter 11 process is incredibly complex and because parties' allegiances can shift constantly during the pendency of the chapter 11 case,[7] DIP counsel is under a duty to keep the court updated as to its disinterestedness.[8] Courts care about disclosure and about playing by the rules. Because the DIP itself generally is run by people who decidedly are not disinterested,[9] it is the disinterested DIP counsel who must look beyond the wishes of the DIP's management team to the overall needs of the estate and its ultimate residual owners.

Sure, all lawyers are officers of the court in the larger sense of the concept. We are not supposed to lie to courts,[10] let our clients lie to courts[11] or engage in conduct "prejudicial to the administration of justice," even when we're not representing a client.[12] Our conduct is proscribed in all sorts of ways to keep the system looking (and acting) fair.

We think that there is more required of those lawyers who are being paid from estate funds. In all such cases it is the unsecured creditors who are ponying up the funds out of their own pockets for the greater good of moving the case forward. In exchange for this cost-shifting, estate counsel needs to be able to distinguish clearly between the direction they are getting from the people managing those constituencies who have an interest in the estate (*e.g.,* the DIP, the creditors' committee) and their role (to keep those constituencies focused on their own roles in chapter 11). With counsel for the creditors' committee, any confusion between direction and role is easy to resolve: The creditors' committee is supposed to look out for the interests of the unsecured creditors as a whole, much as the named plaintiffs in a class action must look out for all plaintiffs in that class action. Fall out of line with that role, and it's time to substitute in new players who better understand their role.

DIPs, however, often do not know who the ultimate owners will be. If the estate is hopelessly insolvent, then creditors will end up as the owners. If the estate holds out hope for equity securityholders though, the DIP has to balance the interests of the creditors and the equity securityholders, which is not an easy task. When we say that the DIP is a fiduciary for the estate, then we are saying that the DIP has this constant, guess-where-we-are-at-any-moment balancing act that it has to maintain. Therefore, DIP counsel has the role of looking over the DIP's shoulder to make sure that the DIP takes *its* role as fiduciary for the estate seriously. The DIP, in essence, acts as a placeholder for the myriad interests that the estate comprises. As a mere placeholder, and as a non-disinterested one at that, the DIP can try to look out for the interests of the estate as a whole, but it is DIP counsel who must ensure that the DIP understands its role and acts accordingly. When the DIP either does not understand (or will not perform) its role, it is DIP counsel's duty to rat on the DIP.

What Are DIP Counsel's Duties?

Although two cases have held that DIP counsel owes no fiduciary duty to the bankruptcy estate,[13] the vast majority of courts have held, for a variety of reasons, that DIP counsel owes some form of fiduciary duty to the bankruptcy estate.[14] (Personally, we think that the courts' frustration with how the DIPs in those cases behaved translated into a frustration that DIP counsel could not control their clients behavior.) Unfortunately, these cases have not clearly defined the nature and extent of those duties—probably because the idea of owing fiduciary duites to the estate conjures up the corollary idea of lawsuits by the "estate" against estate counsel. Even though courts have articulated several different aspects of DIP counsel's fiduciary duty,[15] the duty to rat and the related duty that every lawyer has as an officer of the court are the most frequently discussed fiduciary duties in bankruptcy cases. These duties overlap a bit, and we hope that a brief analysis of each of them will provide some guidance as to the scope of DIP counsel's obligations in this area.

Duty to Rat

In the nonbankruptcy world, lawyers agonize over whether they may rat on (*i.e.,* inform) their clients to reveal wrongdoing because the duty to rat conflicts directly with the duty to keep client confidences.[16] Fortunately, the duty to keep client confidences is by no means an absolute duty; nonetheless, when a lawyer concludes that she has to rat on her client, she still must agonize over how much information she is allowed to reveal. Inside the world of bankruptcy, though, it is because DIP counsel really represents the estate *qua* estate and not just the DIP itself that DIP counsel has a clear duty to rat on those running the DIP.[17] Courts

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5 This concept is what the Supreme Court was getting at in *Commodity Futures Trading Comm'n v. Weintraub*:

> In light of the lack of direct guidance from the Code, we turn to consider the roles played by the various actors of a corporation in bankruptcy to determine which is most analogous to the role played by the management of a solvent corporation. Because the attorney-client privilege is controlled, outside of bankruptcy, by a corporation's management, *the actor whose duties most closely resemble those of management* should control the privilege in bankruptcy, unless such a result interferes with policies underlying the bankruptcy laws.

Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 352 (1985) (citation omitted; emphasis added).

6 *See* Model Rule of Professional Conduct 1.13 (organization as client), www.abanet.org/cpr/mrpc/rule_1_13.html.

7 One of us writes obsessively about this. *See, e.g.,* Nancy B. Rapoport, "The Intractable Problem of Bankruptcy Ethics: Square Peg, Round Hole," 30 *Hofstra L. Rev.* 977 (2002); Nancy B. Rapoport, "Our House, Our Rules: The Need for a Uniform Code of Bankruptcy Ethics," 6 *Am. Bankr. Inst. L. Rev.* 45 (1998); Nancy B. Rapoport, "Seeing the Forest and the Trees: The Proper Role of the Bankruptcy Attorney," 70 *Ind. L.J.* 783 (1995).

8 *See, e.g.,* Fed. R. Bankr. P. 2014; *In re West Delta Oil Co.,* 432 F.3d 347, 355 & n.23 (5th Cir. 2005).

9 *See, e.g.,* Ayer, Clevert, Pelofsky Rapoport & Whyte, Ethics: "Is Distinterestedness Still a Viable Concept? A Discussion," 5 *Am. Bankr. Inst. L. Rev.* 201, 207 (1997).

10 Model Rule of Professional Conduct 3.3, www.abanet.org/cpr/mrpc/rule_3_3.html.

11 *Id.*

12 Model Rule of Professional Conduct 8.4, www.abanet.org/cpr/mrpc/rule_8_4.html.

13 *Hansen Jones & Leta PC v. Segal,* 220 B.R. 434 (D. Utah 1998), *rev'g In re Bonneville Pac. Corp.,* 196 B.R. 868 (Bankr. D. Utah 1996); *In re Sidco Inc.,* 173 B.R. 194 (E.D. Cal. 1994). *Sidco* has probably been overruled by *In re Perez,* 30 F.3d 1209 (9th Cir. 1994).

14 *See, e.g., Brown v. Gerdes,* 321 U.S. 178 (1944) (counsel in bankruptcy cases seeking compensation from court are held to fiduciary standards); *ICM Notes Ltd. v. Andrews & Kurth LLP,* 278 B.R. 117, 126 (S.D. Tex. 2002), *aff'd,* 324 F.3d 768 (5th Cir. 2003); *In re Taxman Clothing Co.,* 49 F.3d 310 (7th Cir. 1995); *In re Perez,* 30 F.3d 1209 (9th Cir. 1994); *In re JLM Inc.,* 210 B.R. 1926 (2d Cir. B.A.P. 1997) (holding both management and debtor's counsel have fiduciary duties to bankruptcy estate in chapter 11 case when debtor's counsel disobeyed new management directions and objected to attempt to dismiss case where new management was unperfected secured creditor seeking to secure its position to detriment of bankruptcy estate). *See also DIP's Attorney, supra* n. 3.

15 Various other duties that courts have stated may be part of DIP counsel's fiduciary duties include: (1) the duty to investigate the debtor and management; (2) the duty to not require debtor to make payments that would endanger a debtor's business operations; (3) the duty to review from bankruptcy estate's standpoint those critical motions filed in a debtor's case; and (4) the duty to police the debtor and its management. *See also DIP's Attorney, supra* n. 3.

16 *See* Model Rules of Professional Conduct 1.6, www.abanet.org/cpr/mrpc/rule_1_6.html.

17 As *Brown v. Gerdes* discussed above, *supra* n. 14, as management of a chapter 11, the DIP's management is clearly not DIP counsel's client, so the attorney-client privilege should rarely be an issue. *See* n. 6, *supra.* In the event there is any significant question as to whether a disclosure would violate the DIP's attorney-client privilege, DIP counsel should consider making a "noisy withdrawal." *See generally* Bowles, "Noisy Withdrawals: Urban Legend or Invaluable Ethical Tool?," 20 *Am. Bankr. Inst. J.* 26 (Oct. 2001) [hereinafter Bowles, "Noisy Withdrawals"].

have uniformly held that in cases in which management has engaged in misconduct, DIP counsel has the duty to disclose this misconduct in some manner.

The largest problem in this area is determining how serious the misconduct should be before the DIP counsel must disclose it. Although courts haven't articulated an easy, concise test, several courts have noted that DIP counsel can't "close their eyes" to matters having an adverse effect on the bankruptcy estate.[18] Nevertheless, courts have generally required the misconduct to be severe before requiring disclosure. Among the types of misconduct that courts have held must be disclosed are:

a. violation of court orders by insiders. *See, e.g., In re Food Management Group, LLC.,* 380 B.R. 677 (Bankr. S.D.N.Y. 2008).

b. conflicts of interest with another court-approved professional. *See, e.g., In re Sky Valley Inc.,* 135 B.R. 925 (Bankr. N.D. Ga. 1992).

c. refusal to pursue claims against insiders. *See, e.g., In re DeVlieg Inc.,* 174 B.R. 497 (N.D. Ill. 1994).

d. failure to properly market or sell estate assets. *See, e.g., In re Wilde Horse Enterprises Inc.,* 136 B.R. 830, 838 (Bankr. C.D. Cal. 1991).

e. conversion, concealment or misuse of estate property. *See, e.g., In re Ward,* 894 F.2d 771, 776 (5th Cir. 1990); *In re Brennan,* 187 B.R. 135 (Bankr. D. N.J. 1995); *In re Barrie Reed Buick-GMC,* 164 B.R. 378 (Bankr. S.D. Fla. 1994).

The basis of DIP counsel's duty to disclose improper conduct arises from the significant court involvement in both the oversight of the bankruptcy estate and the attorney-appointment process. As noted by the Supreme Court's observation in *Brown v. Gerdes,* attorneys whose retention and fees are subject to court approval are held to a fiduciary standard by that court.[19] The extent of court involvement, akin in part to class action litigation, is different from other nonbankruptcy litigation, where there is little court oversight of the affairs of the litigants outside court. Therefore, the very nature of court oversight of the retention and payment of DIP counsel requires the imposition of the duty to rat on DIP counsel. Our advice? Start off by treating the problem like a MRPC 1.13 (organization as client) problem: Go higher and higher within the DIP to persuade management to do the right thing. If nothing works, then you may have to ask the court to replace management or seek to withdraw as counsel. That should signal a problem without running the risk of over-disclosing confidences. If management opposes these actions, then you may have to disclose more information to the court or—worse yet—suggest the appointment of a trustee.[20]

Duty as an Officer of the Court

Closely related to the duty to rat is an attorney's duty as an officer of the court[21] under the "candor to a tribunal" and other related ethics rules.[22] In the leading case discussing the duties of DIP counsel as an officer of the court, the Fifth Circuit in *In re Ward,* 894 F.2d 771 (5th Cir. 1990), held that an attorney would have to disclose the existence of any concealed assets and possible criminal activity by management that the attorney knew may have taken place.[23] Although this duty to disclose is similar to the duty to rat, all attorneys owe a duty to keep the legal system honest by virtue of their role as officers of the court; this duty does not arise from DIP counsel's fiduciary duty to the bankruptcy estate. As with the duty to rat, however, and given the extent of court involvement with bankruptcy estates, it seems likely that courts will be far more sensitive to an attorney's duty as an officer of the court in the bankruptcy context.[24]

Conclusion: The Law Is the Law

To steal Dave Barry's catchphrase, we are not making this up.[25] We are not making up the fact that representing the DIP is a representation different from other types of representations, even other types of representations paid for out of estate funds. Creditors' committee counsel know that they are always representing the unsecured creditors; only counsel for the hopelessly insolvent DIP can be completely sure that she has no duties to equity as well. We are not making up the fact that management of the DIP can sometimes lose sight of the fact that maximizing and reorganizing the estate, not self-preservation of management's perks, is the point of chapter 11. We do not mean to create an automatic adversarial relationship between the DIP and DIP counsel; most of the time, we expect DIP management to do the right thing and not worry about the risk of DIP counsel's duty to rat. We do mean to say that for those for whom chapter 11 operates not as a handbreak but as a piggybank, DIP counsel must act as an extra check on the integrity of the bankruptcy process. The estate, and all constituents who expect to draw from it, deserve no less. ■

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18 *See In re Food Management Group LLC,* 380 B.R. 677, 708 (Bankr. S.D.N.Y. 2008); *In re St. Stephen's,* 350 East 116th St., 313 B.R. 161, 171 (Bankr. S.D.N.Y. 2004).

19 321 U.S. at 182.

20 One caveat: State bars often do not understand bankruptcy law. What we are suggesting about a duty to rat might not fly in your home state, even though some states allow disclosure of imminent financial fraud. The fact that your state bar may misunderstand your duty to rat puts you in a precarious position: Fail to rat, and you run the risk of angering the bankruptcy court; rat, and you run the risk of DIP management bringing you before your state bar for a breach of confidentiality. Hey, we never said that bankruptcy law was easy.

21 *See Baker v. Humphrey,* 101 U.S. 494 (1879); *In re Arlan's Dept. Stores Inc.,* 615 F.2d 925, 941 (2d Cir. 1979).

22 For a further discussion of the effect of the Rules of Professional Conduct related to an attorney's obligation of candor to a tribunal, *see generally* Bowles, "Noisy Withdrawals," *supra* n. 148; *see also supra* n. 104-26 and accompanying text.

23 894 F.2d at 776.

24 *See Food Management Group,* 380 B.R. at 709-715, where a bankruptcy court refused to dismiss a lawsuit for breach of fiduciary duty and fraud on the court against DIP counsel seeking damages far in excess of DIP counsel's fees.

25 http://en.wikipedia.org/wiki/Dave_Barry.