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Ethical Issues That Arise in Bankruptcy

ROBERT G. RICHARDSON
JACKSON WALKER, L.L.P.
901 Main Street, Suite 6000
Dallas, Texas 75202
Tel: (214) 953-6166
Fax: (214) 953-5822
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ETHICAL ISSUES THAT ARISE IN BANKRUPTCY

Introduction

Although the United States economy continues to flourish, bankruptcy filings have reached a record high over the last five years. The factor that probably has the most impact on the bankruptcy filing statistics is the ability to borrow money. Individuals have it through credit cards. Businesses have it through the generosity of lending institutions. The restraints on access to credit have loosened. It is anticipated that business bankruptcy filings will increase through 2001, driven to some extent by credit extended to allow companies to acquire other companies generating extreme debt pressure. More public companies filed for bankruptcy in 1999 than in any year since 1986. Allen Michel and Israel Shaked, The Paradox of Corporate Bankruptcy in a Robust Economy, ABI Journal, Nov. 2000, pp. 26-27.

Since the mid-1980’s bankruptcy law has become increasingly relevant to issues with which a federal litigator must deal. As a federal court practitioner you will likely be exposed to the complexities of bankruptcy law either directly in a bankruptcy case or because a bankruptcy case has an impact on non-bankruptcy litigation. While many of the issues relating to ethics to which a federal court practitioner is exposed in federal civil litigation are also present in the bankruptcy context, there are numerous additional situations that are unique to a bankruptcy case about which a federal practitioner should be aware because they might raise ethical problems. Many of these special areas do not present traditional ethical issues that are covered in disciplinary rules or which might lead to punishment through the Texas State Bar disciplinary procedures but instead relate to

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fiduciary duties and disclosure requirements that, if violated, may result in an attorney having to withdraw from the representation and even suffering economic penalties, including the denial by the bankruptcy court of compensation.

There are several reasons why the nature of the ethical issues are likely to be more complex as they relate to a bankruptcy case than in a federal lawsuit. First, in a bankruptcy case there are usually more parties in interest than in a federal lawsuit and many of the parties have interests that are different from those of the traditional plaintiffs and defendants. Although there are plaintiffs and defendants in bankruptcy adversary proceedings, the parties who have an interest in the general administration of the case may include a debtor (often a debtor-in-possession in a chapter 11 reorganization case under the Bankruptcy Code), trustee, examiner, United States Trustee and a variety of secured and unsecured creditors, priority administrative creditors, and other parties in interest such as the Securities and Exchange Commission, the Internal Revenue Service and state and federal environmental protection agencies. While on some issues in a bankruptcy case the interests of two or more of these parties may be aligned, the same parties may be in opposition on other issues. The tensions and conflicts between and among the parties are often the most intense in chapter 11 cases because a debtor-in-possession will be aggressively attempting to maintain as many assets in the estate as possible so that they will be available to the reorganized company after a plan is confirmed.

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2 Noting the complexity of dealing with ethical conflicts in a bankruptcy case, the American Law Institute determined in 1997 that its project on the Restatement of the Law Governing Lawyers would not treat the subject.

3 Adversary proceedings are lawsuits that are litigated in a bankruptcy “case”. A bankruptcy case (as distinguished from a “proceeding”) is the legal vehicle for the administration of the debtor’s estate. See Sections 301, 302, 303 and 304 of the Bankruptcy Code regarding the commencement of a bankruptcy case. All references to the Bankruptcy Code are to title 11 of the United States Code, sometimes hereinafter referred to as the “Code.”
while the creditors may want assets to be distributed as soon as possible in as large amounts as possible to satisfy claims.

A second significant difference between federal civil litigation and a bankruptcy case is the role of the attorney. In contrast to a federal lawsuit, often attorneys in a bankruptcy case are part litigation advocates and part business counselors. The roles of attorneys in a bankruptcy case are further complicated by the fact that unlike litigation, which is typically based on past conduct and circumstances, a liquidation or reorganization case requires active participation by an attorney in the administration of the case and, in a chapter 11 case, as a counselor in aspects of the operation of the debtor’s business. An attorney, as a multifaceted performer on the bankruptcy stage, has to deal with complex business, administrative and legal issues in the stressful atmosphere of a failed enterprise that is often trying desperately to stay in operation while it must comply with demanding provisions of the Bankruptcy Code and Rules. At a minimum, a federal practitioner involved in a bankruptcy case must be knowledgeable about the Bankruptcy Code, Bankruptcy Rules, Federal Rules of Civil Procedure and local bankruptcy and federal rules. Because of the maze of legal and business factors that are in play in a bankruptcy case the ethics of an attorney may be tested.

Unfortunately, an attorney has little guidance regarding many ethical matters because courts have dealt with such issues in a less than consistent way. Some courts have been reluctant to become involved in a matter of ethical conduct unless it adversely

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4 References to “Bankruptcy Rules” are to the Federal Rules of Bankruptcy Procedure. You should also be aware that local bankruptcy rules have been promulgated that apply to bankruptcy cases pending in the Northern District of Texas as well as the other districts in Texas. Also most Bankruptcy Judges have their own local, local rules.
impacts the litigation process or might taint a trial.\footnote{5} Other courts have been more active because of a concern that unless the judge responds to an ethical issue, it might not be timely and properly resolved.\footnote{6} Quoting from In re Consolidated Bancshares, Inc., 785 F.2d 1249, 1256 (5th Cir. 1986), Judge Abramson, one of the four bankruptcy judges in the Dallas Division of the Northern District of Texas,\footnote{7} noted in In re Kendavis Industries International, Inc., 91 B.R. 742, 751 (Bankr. N.D. Tex. 1988) that the Fifth Circuit was one of the courts that was particularly “sensitive to preventing conflicts of interest.” As reflected by many of the opinions cited below, judges in the Fifth Circuit, and especially in the Northern District of Texas, have been activists in the area of attempting to ensure that high ethical standards are maintained by attorneys appearing in bankruptcy cases. The bankruptcy judges in the Northern District of Texas are demanding in their expectations of ethical conduct from the attorneys practicing in this district and have not been timid in fashioning severe sanctions where they have discovered ethical lapses and failures to comply with the Bankruptcy Code, Bankruptcy Rules and the special fiduciary duties required of professionals in a bankruptcy case.

Because there is not a national, state or local code of professional responsibility promulgated specifically for practitioners involved in bankruptcy cases, an attorney should principally rely on the code of professional responsibility adopted by the forum state.\footnote{8} The attorney should also be familiar with the ABA Model Rules of Professional Conduct (“ABA Rules”) because some bankruptcy courts have considered such rules when evaluating an
attorney’s conduct in a bankruptcy case. In Texas the applicable ethical rules are set forth in the Texas Disciplinary Rules of Professional Conduct ("Texas Rules").

The application of sometimes poorly defined ethical concepts to the conduct of attorneys is particularly challenging in a bankruptcy case because a client (e.g., debtor, trustee or creditors’ committee) owes duties to other entities and persons, such as creditors. A debtor, trustee and creditors’ committee are fiduciaries with respect to the bankruptcy estate and must operate for the ultimate benefit of its creditors. To complicate the issue further, some courts have indicated that an attorney for a debtor or trustee may also have a fiduciary duty to creditors and the court even though such duties might conflict with the attorney’s obligations to a client. The courts have failed to be precise in their establishment of parameters with respect to such duties.

The extent to which an attorney for a debtor or trustee may be held responsible for the conduct of a client is unclear. The more egregious the client’s conduct, the more likely the attorney may be expected by the court and the creditors to exercise some control over

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10 The Texas Rules are in Section 9 of Article X (Discipline and Suspension of Members) of the State Bar Rules. The Texas Rules were promulgated effective January 1, 1990 and have been amended at various times since then. The Texas Rules "define proper conduct for purposes of professional discipline." Preamble: Scope, Texas Rules. There are also the Texas Rules of Disciplinary Procedure which were adopted effective May 1, 1992 and have also been amended. These rules establish procedures by which attorneys are disciplined.

11 See e.g., Sections 323, 704, 721, 1106 and 1107 of the Bankruptcy Code. ABA Rule 1.2, Scope of Representation, provides that where a client is a fiduciary, the attorney may have special obligations in transactions involving the beneficiary.

12 Hansen, Jones & Leta, P.C. v. Segal, 220 B.R. 434, 448 (Bankr. D. Utah 1998)(duty of attorney owed to bankruptcy court to investigate validity of his/her client’s story prior to initiating litigation.); In re Rivers, 167 B.R. 288, 300 (Bankr. N.D. Ga. 1994) (duty of attorney for incompetent debtor in possession to advise U.S. Trustee and the court of such fact and failure to do so is a breach of duty resulting in denial of compensation); In re United Utensils Corp., 141 B.R. 306, 309 (Bankr. W.D. Pa. 1992) (an attorney for the debtor has a fiduciary duty not only to the debtor, but to act in the best interests of the estate, including the creditors); In re Wilde Horse Enterprise, Inc, 136 B.R. 830, 840 (Bankr. C.D. Cal. 1991) (as an officer of the court, the attorney for the debtor in possession has a high fiduciary duty to the corporate entity estate, not its principals, and to act in the best interest of the creditors); In re Kelton Motors, Inc, 109 B.R. 641, 650 (Bankr. D. Vt. 1989) (an attorney approved by the court to represent the debtor is a fiduciary to the court).
the client or, at least, give notice to the court of the client’s improper actions. If an attorney ignores the improper or even imprudent actions of a client, she must be prepared to suffer economic punishment in the form of the disallowance of fees or other sanctions. Counsel for debtors have suffered sanctions through the disallowance of fees for permitting clients to (a) generate indebtedness (including administrative expenses owed to attorneys) during a bankruptcy case knowing there will be insufficient assets in the estate to satisfy such debt,13 (b) resist conversion of the case to chapter 7 after reorganization under chapter 11 was clearly impossible,14 (c) operate in chapter 11 for the sole purpose of paying secured debt for which the debtor’s principals were personally liable,15 (d) file and proceed with a chapter 11 case while aware that a plan would never be confirmed,16 and (e) prosecute litigation when the costs exceeded the amount likely to be recovered.17

Actual harm to the estate or waste of judicial resources may not be required as a condition to punitive action against an attorney if a conflict of interest exists. In In re Granite Partners, L.P., 219 B.R. 22 (Bankr. S.D.N.Y. 1998), the bankruptcy court identified a conflict of interest with the law firm representing the bankruptcy trustee but held that the trustee was not required to prove that the conflict led to actual misconduct by the law firm. Granite Partners, 219 B.R. at 42.

16 In re Coones Ranch, Inc., 7 F.3d 740 (8th Cir. 1993).
Although attorneys have been penalized for conduct that wastes judicial resources and only benefits non-debtor insiders at the expense of creditors, generally the courts have not attempted to redefine the attorney-client relationship so dramatically that the attorney assumes responsibility for the management of a debtor’s business. The officers and directors of a business entity debtor still are required to make the final management decisions. A debtor client will not be permitted by a court to use its attorney to shield improper conduct. If the activity is improper when done by a client; it is improper when done by its attorney. Although an attorney for a debtor has a duty of loyalty to a client, such duty is not unlimited.

While not technically ethical rules, certain sections of the Bankruptcy Code and rules of the Bankruptcy Rules require substantial disclosure of information from an attorney whose employment must be approved by the court. These Code provisions (Sections 326 through 329) and rules (Rules 2014, 2016 and 2017), must be followed precisely to avoid possible disallowance or reduction of compensation.

An attorney involved in a bankruptcy case also must be aware of criminal statutes that apply to not only the conduct of attorneys for a debtor, trustee and creditors’ committee but to attorneys for individual creditors and other parties in interest. In addition to the fines and incarceration penalties provided by such statutes for criminal conduct relating to a bankruptcy case, a court has the power to order a variety of forms of sanctions for non-criminal but improper or unethical conduct. For example, a court may preclude an attorney from appearing before the court on future matters. This sanction has been applied by a bankruptcy judge in this District.

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The following areas that will be discussed below are some of the most troublesome with respect to potential ethical and disclosure violations in the context of a bankruptcy case:

(1) Representation of multiple parties (debtor and affiliate/insider, creditors);
(2) Previous and current representations;
(3) Pre-bankruptcy planning;
(4) Personal interest of attorney;
(5) Failure of debtor to disclose assets; and
(6) Improper conduct of debtor.

Simultaneous Representation of Debtor and Affiliate/Insider
An attorney should not represent multiple clients who have interests that are antagonistic.20 This potential ethical problem is, of course, not unique to a bankruptcy case. Outside of the bankruptcy context, however, if a company is closely held, an attorney will frequently be able to represent simultaneously a business entity and one or more officers, directors or insiders without having a conflict because usually their respective interests are aligned. While some bankruptcy courts in special circumstances have permitted such multiple party representation in the same case,21 the practice should generally be avoided in a bankruptcy case.22 Section 327(c) of the Code permits representation of multiple parties under certain circumstances. The section provides that a

20 ABA Rule 1.7 (Conflict of Interest: General Rule); Texas Rule 1.06 (Conflict of Interest: General Rule).
22 In re Grabill, 113 B.R. 966, 971 (Bankr. N.D. Ill. 1990) (“The only truly safe harbor for those professionals subject to the stringent fiduciary standards of §§ 327 and 1103, is to represent only a single client when that client is in, or likely headed for, bankruptcy court.”) Note that ABA Rule 1.13(e), authorizes an attorney to represent an entity and its principals at the same time, provided there is no actual conflict of interest.
person is not disqualified for employment by a bankruptcy debtor or trustee merely because the attorney represented or even represents a creditor, unless there is a finding that an actual conflict exists (e.g., there would be an actual conflict if the attorney represented a debtor and a creditor in the same bankruptcy case). If, however, at the time of the consideration by the court of the approval of the employment of the attorney for the debtor the disclosure required by Bankruptcy Rule 2014(a) (Employment of Professional Persons) of the prior or current creditor representation is not made, then the attorney will be subject to sanctions when the non-disclosure is discovered.23

In In re Granite Partners, L.P., 219 B.R. 22 (Bankr. S.D. N.Y. 1998), the chapter 11 trustee employed a law firm to represent the debtor and to help prosecute potential claims against certain broker-dealers. (The debtor entered bankruptcy after the value of its investments declined and the broker-dealers liquidated collateral to satisfy margin calls they made. Granite Partners, 219 B.R. at 27.) The law firm failed to disclose current representation of a broker-dealer which would potentially be a target of claims, and the bankruptcy court reduced the fees of the law firm 59%. Granite, 219 B.R. at 44.

In the context of a bankruptcy case for purposes of employment pursuant to Section 327 of the Code many courts have rejected the ethical concept that a “potential” conflict does not disqualify an attorney.24 Representing any party in a bankruptcy case in addition to the debtor is an “ethical trap” that should be avoided.25 Special counsel, however, can

23 In re Granite Partners, L.P., 219 B.R. 22 (Bankr. S.D.N.Y. 1998) (firm denied partial payment of fees for failure to disclose current representation of potential targets of turnover actions); In re Marine Outlet, Inc., 135 B.R. 154 (Bankr. M.D. Fla. 1991); In re Rusty Jones, 134 B.R. 321 (Bankr. N.D. Ill. 1991) (attorney suspended from practice and fees reduced for failure to disclose former relationship that was adverse to the estate).
be employed so long as the attorney is disinterested with respect to the specific engagement.\textsuperscript{26} The problems inherent in any simultaneous representation of a debtor and an affiliate or insider in a bankruptcy case are magnified if an insider were also a creditor or a potential defendant in an avoidable transfer action, or in a directors’ and officers’ liability lawsuit. The attorney’s loyalties would not be consistent because as counsel for the debtor the attorney should promote the aggressive recovery of avoidable transfers and the prosecution of all damage claims, but the potential defendant insider client would, obviously, want the claim to be dropped.

Although a \textit{per se} disqualification rule relating to multiple representation has been rejected by some courts,\textsuperscript{27} most courts have scrutinized such multiple client representation so closely that, as a practical matter, an attorney would be imprudent to attempt to represent a debtor and a debtor’s principal at the same time even if the representation of the principal were in a matter unrelated to the bankruptcy case.

A leading Northern District of Texas bankruptcy court opinion on simultaneous principal and debtor representation is \textit{In re Kendavis Industries International, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988)}. In that opinion Bankruptcy Judge Abramson severely sanctioned the law firm representing the debtor after the court concluded that the attorneys’ services were, in fact, for the benefit of affiliates and equity interest holders rather than for the debtor corporation. The court determined that a serious conflict of interest existed. In reaching that conclusion, the court held that “whenever counsel for a debtor corporation has any agreement, express or implied, with management or a director of the debtor, or with a shareholder, or with any central party, to protect the interest of that party, counsel

\textsuperscript{26} Bankruptcy Code § 327(e); \textit{In re Argus Group 1700, Inc., 199 B.R. 525 (Bankr. E.D. Pa. 1996)} (role of special and general counsel for debtor blurred).

\textsuperscript{27} See, \textit{In re Office Products of America, Inc., 136 B.R. 983 (Bankr. W.D. Tex. 1992)"}
holds a conflict. That conflict is not potential, it is actual, and it arises the date that representation [of the debtor] commences.28

The multiple party representation conflict analysis is more exacting in a bankruptcy case because the debtor has fiduciary responsibilities to creditors that are different from, and more extensive than, the responsibilities of a non-debtor company to its shareholders. Although multiple client representation in a bankruptcy case should be avoided, if an attorney believes circumstances of the case justify such simultaneous engagements, the attorney must fully disclose to the court and the creditors all facts that relate to the respective representations.29 If the representations of the debtor client and the creditor client are in different cases, the likelihood of obtaining approval from the court is increased but there must be no overlap in the issues and the clients must approve the representation after full disclosure by the attorney.

Problems may also arise in the context of attorney compensation. It is not unusual for a debtor’s attorney to be paid by an insider for prospective bankruptcy services to be performed for the business entity. The ethical concern that arises from such payment relates to whether the attorney will truly have loyalty to the business debtor or will the insider, as the source of the payment, control or dominate the attorney’s representation of the debtor. This payment from an insider must be disclosed in the initial employment application as required by Bankruptcy Rule 2014 and also in any application for approval of compensation submitted pursuant to Sections 330 and 331 of the Code and Bankruptcy Rule 2016. An attorney for a debtor who receives a payment from any entity other than the debtor client should exercise extreme care to avoid being influenced by the non-debtor

29 Rome v. Braunstein, 19 F.3d 54 (1st Cir. 1994); In re McNar, Inc., 116 B.R. 746, 754 (Bankr. S.D. Cal. 1990) (existence of even an arguable conflict must be disclosed).
payor. It is likely that the court and the creditors will more carefully monitor and scrutinize the services of such an attorney to attempt to ensure that the attorney does not violate the duty of loyalty to the debtor client who has a fiduciary duty to the creditors. That fiduciary duty is not shared by the insider/payor.

Another ethical problem may arise when the attorney for a debtor formerly represented an insider. The special fiduciary responsibilities of a debtor to the creditors requires the attorney for the debtor to ensure that there is a separation of the current representation of the debtor from the attorney’s former engagement by the insider. The rules that apply in a typical commercial context that allow some multiple representations of an insider and the business entity are not applicable in a bankruptcy case.³⁰ If the previous representation, although terminated, were on a matter substantially related to issues in the bankruptcy case, the court will presume that confidential information was disclosed during such representation. If such information would prevent the attorney from committing full loyalty to the debtor or give rise to a conflict with the debtor’s or creditors’ interests then it would preclude the representation of the debtor.³¹ An undisclosed adverse interest arising from previous representation can support the disallowance of all compensation to an attorney.³²

An example of a situation where a law firm was disqualified from representing a client because of a potential breach of duty of loyalty is In re Irwin J. Jaeger, 213 B.R. 578 (Bankr. C.D. Cal. 1997). A firm had jointly represented a corporation and other defendants in a state court fraudulent transfer lawsuit prior to the bankruptcy of the corporate defendant and an individual defendant. After the corporation and the individual filed

³⁰ In re Amdura Corp., 139 B.R. 963 (Bankr. D. Colo. 1992)
³¹ In re American Airlines, Inc., 972 F.2d 605 (5th Cir. 1992); Duncan v. Merrill, Lynch, Pierce, Fenner & Smith, 646 F.2d 1020, 1028 (5th Cir. 1981).
bankruptcy the firm terminated its representation of those clients but continued representing the non-debtor defendants in the state court lawsuit. The individual and the corporation, through their chapter 7 trustee, commenced a fraudulent transfer action against the non-debtors who were defendants in the state court action. The bankruptcy court granted the trustee’s motion filed in the corporate chapter 7 case to disqualify the firm from representing the defendants in the bankruptcy action on the ground that the firm’s continued representation of clients defending claims asserted by the trustee for a former corporate client violated Rule 3-310 of the California Rules of Professional Conduct that prohibits representation of clients that have active or potential conflicting interests. The continued representation of the non-debtor clients was inconsistent with the firm’s duty of loyalty to its former corporate client. The court also held that the chapter 7 trustee for the corporate debtor had standing to raise the issue. The court noted, however, that the trustee of an individual debtor who was a former client would not have had standing to bring a disqualification motion. In the chapter 7 case of an individual, the trustee and the chapter 7 estate are “fundamentally separate” from the prepetition individual debtor for purposes of the application of the doctrine of duty of loyalty.

**Simultaneous Representation of Multiple Creditors**

Ethical issues also arise frequently in bankruptcy cases with respect to the conduct of attorneys who are not required to have their employment approved by the bankruptcy court pursuant to Section 327 of the Code. A situation that generates potential conflicts of interest is where an attorney is engaged by numerous creditors who have claims in the same bankruptcy case. So long as these creditor clients have interests that are not adverse and they consent to the joint representation, an attorney is not precluded from
representing two or more creditors.\textsuperscript{33} Often such multiple creditor representation is economically advantageous to the clients because they can mitigate the expense of participation in a case. Creditors with small claims or creditors in cases in which the distribution will be limited are often reluctant to employ their own counsel to protect their interests because the legal fees might exceed any net benefit from such representation.\textsuperscript{34}

Before accepting such multiple creditor representation an attorney should understand fully the nature of the claims of the potential creditor clients (e.g., secured, unsecured, priority, administrative, etc.), and attempt to anticipate how those claims might be treated in the case (e.g., will one or more of the creditors have a claim that will be the subject of an objection or be a defendant in an action to avoid a transfer). The more dissimilar the claims, the more likely creditors will have dissimilar goals. As the goals diverge, the attorney becomes increasing challenged to represent the interests of each member of the creditor group. Generally an attorney should not attempt to represent a creditor with a secured or even partially secured claim while representing an unsecured creditor. The interests of such creditors are often adverse. For example, a secured creditor wants to ensure the integrity and availability of its collateral while an unsecured creditor scrutinizes all security interests to attempt to defeat their perfection so that additional unencumbered assets are available to pay unsecured claims.

Likewise, counsel should avoid representing any individual creditor while representing a creditors’ committee.\textsuperscript{35} Although it might seem that their interests are the

\textsuperscript{33} ABA Rule 1.7; Texas Rule 1.06.

\textsuperscript{34} Sometimes creditors can avoid a direct legal fee expense altogether if they become members of a creditors’ committee whose counsel is paid out of the estate’s assets. Of course, as members of a committee the creditors must act as fiduciaries of the creditors represented by the committee and not strictly in their self-interest.

\textsuperscript{35} In re Whitman, 101 B.R. 37 (Bankr. N.D. Ind. 1989).
same, the conflicts in interest might be significant. When representing a creditors’ committee the attorney’s client is the committee entity. The attorney for the committee does not represent its individual members nor the creditor body. No attorney should have to struggle with attempting to harmonize loyalty to the committee which has a fiduciary duty to all the creditors with loyalty to an individual creditor who is attempting to maximize its own recovery. Often a committee must make compromises that, while benefitting the creditors as a group, might be contrary to the interest of a particular creditor. A committee might even be a plaintiff in a lawsuit seeking to recover damages from a creditor for the benefit of the bankruptcy estate.

If an attorney represents more than one creditor or other interest holder in the same bankruptcy case, the attorney must file a verified statement pursuant to Bankruptcy Rule 2019 identifying all of the clients and describing the nature and amount of the claims or interests, all relevant facts and the circumstances of the employment. If changes in the representation occur, then supplemental statements must be filed. Bankruptcy Rule 2019(b) provides the punishment for failure to comply with the disclosure requirement. The court has latitude in the form of the sanctions that may be imposed for failure to comply with the rule but clearly the client, as well as the attorney, may be penalized.

**Disclosure**

To be eligible to represent a debtor, trustee or committee, an attorney must not hold or represent an interest adverse to the estate and must be a disinterested person. As defined in Section 101(14) of the Code, a “disinterested person” is a person that, inter alia, is not a creditor, equity security holder or insider and does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders by

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36 Bankruptcy Code § 327(a).
reason of any direct or indirect relationship to the debtor. An attorney has an affirmative
duty to disclose information that has any relevance to a disinterestedness analysis. This
will afford the court and the other parties in interest an opportunity to review potentially
significant information so that a determination can be made at the outset of the
engagement whether it should be permitted. The attorney does not have the discretion to
withhold information because it is solely within the court’s authority to decide whether the
facts require disqualification.37 If an attorney fails to disclose facts which would reveal a
lack of disinterestedness in the context of the attorney’s application for employment filed
pursuant to Section 327, it is likely that sanctions will be levied against the attorney and the
attorney may be forced to withdraw from the representation of the client.38

The attorney seeking approval of employment has the burden to make full
disclosure.39 The court, the United States Trustee and the creditors do not have an
obligation to investigate the attorney’s relationships that might support disqualification.
Bankruptcy Rule 2014(a) requires that any professional seeking employment in a
bankruptcy case pursuant to Sections 327, 1103 or 1114 of the Bankruptcy Code disclose
in a verified statement all of the “person’s connections with the debtor, creditors, any other
party in interest, their respective attorneys and accountants, the United States Trustee, or
any person employed in the office of the United States Trustee.”

The disclosure requirement does not cease when the attorney has been approved
for employment. If a relevant fact is revealed to the attorney after the engagement has

37 Rome v. Braunstein, 19 F.3d 54 (lst Cir. 1994); In re Arlans Dept. Stores, 615 F.2d 925 (2d Cir.
38 In re Granite Partners, L.P., 219 B.R. 22 (Bankr. S.D.N.Y. 1998); In re Begun, 162 B.R. 168, 177
(Bankr. N.D. Ill. 1993) (“Failure of a professional person to comply with the requirements of either the
Code or the Rules can result in a reduction or denial of compensation.”).
39 In re Begun, 162 B.R. 168, 177 (Bankr. N.D. Ill. 1993) (a retention application must reveal all
relevant relationships); In re Envirodyne Industries, Inc., 150 B.R. 1008, 1020-21 (Bankr. N.D. Ill. 1993)
(even trivial connections must be disclosed).
been approved, the attorney must file a supplemental Rule 2014 verified statement.\textsuperscript{40} Similarly, if an action of the debtor changes the disinterested status of the attorney, the attorney must file a supplemental Rule 2014. In \textit{Matter of Olsen Industries, Inc.}, 222 B.R. 42 (Bankr. D. Del. 1997), the law firm employed as debtor’s counsel was already representing the debtor in an ongoing civil lawsuit. The debtor was closely allied with a co-defendant in the lawsuit which was paying the law firm’s fees. The law firm conditioned its employment as debtor’s counsel on agreement that it would not represent the debtor in any action adverse to the co-defendant which was paying the law firm’s fees.

Prior to filing its bankruptcy petition, the debtor entered an agreement with the co-defendant which gave the co-defendant the unilateral right to settle the lawsuit and designated the percentages that the company and the debtor would receive upon settlement. After the bankruptcy, the debtor decided not to assume the agreement regarding settlement percentages which it deemed an executory contract, and disputes arose between the co-defendant and the debtor over how the settlement would be apportioned and over how the litigation expenses would be paid. \textit{Olsen}, 222 B.R. at 59. The law firm did not at that point file a supplemental Rule 2014 statement stating its conflict over the debtor’s adverse position to the co-defendant. \textit{Olsen}, 222 B.R. at 59. The law firm was required to disgorge a portion of its fees for the representation of the debtor after the conflict arose. \textit{Olsen}, 222 B.R. at 63.

It is not infrequent that in a case with hundreds of creditors an attorney for a debtor, particularly if a member of a law firm having numerous attorneys, will have to file several verified statements under Rule 2014 as relationships with creditors are discovered. This is

\textsuperscript{40} \textit{Matter of Olsen Industries, Inc.}, 222 B.R. 49, 59 (Bankr. D. Del. 1997); \textit{In re McNar, Inc.}, 116 B.R. 746, 753 (Bankr. S.D. Cal. 1990) (“Disclosure is also an ongoing responsibility. If potential conflicts arise after the initial Application and disclosure, they should be brought to the court’s attention promptly.”)
even more likely to happen if the case is filed on an expedited basis where there is a limited opportunity for a debtor’s attorney to do a thorough conflicts check. Although having to file multiple Rule 2014 statements is preferable to non-disclosure, if an attorney repeatedly files supplements it may reflect a lack of diligence by the attorney. At some point the United States Trustee, the creditors and probably the court may question the attorney’s good faith or even competence. A significant effort should be made as soon as possible after the case is commenced to make a full disclosure of all relationships.

The disqualification of an attorney for lack of disinterestedness is not because of any deficiency in the integrity or ethics of the attorney but is based on an objective standard applied to the relationships the attorney has with the various parties in interest in a bankruptcy case.\(^\text{41}\) However, an ethical breach would occur if an attorney intentionally fails to disclose relevant information. Such an ethical lapse will likely result in complete disallowance of compensation for services rendered to the time of disqualification and, if interim fees have been paid, the disgorgement of fees and expenses.

An attorney debating the extent of disclosure that should be made should also be aware that if there is disqualification for inadequate disclosure, the client and probably the creditors will also suffer. The delay, expense and distraction of removing an attorney and substituting new counsel can be significant, particularly after the case has been pending for several months. Some reorganization cases cannot afford such an additional economic burden. An argument can be made that an attorney who is disqualified for intentionally failing to disclose relevant information should not only lose any right to compensation but should bear the adverse economic impact of having new counsel engaged and educated.

regarding the case. The creditors should not have to pay such costs particularly when an
attorney has acted in bad faith in failing to disclose relevant information.

**Prepetition Counseling**

Attorneys are becoming increasingly aggressive in the advice they give to
prospective bankruptcy debtors regarding transactions that the debtor might undertake
prepetition to reduce the adverse economic impact on the debtor from commencing a
bankruptcy case. Likewise, prospective debtors are becoming more sophisticated about
asset sheltering schemes and are putting pressure on attorneys to create such schemes to
attempt to exclude assets from the bankruptcy estate. Because these dynamics generate
considerable stress in the prepetition environment, a debtor’s attorney must be extremely
sensitive to ethical considerations that arise in the context of such counseling. Possibly of
even greater potential concern to an attorney than the ethical challenges are the criminal
implications of prepetition conduct adverse to the interests of creditors.42 Even if the
conduct were not illegal, an attorney who assists a client in fraudulent transfers, including
transactions that result in unnecessary dissipation of assets, might be sanctioned.43

An attorney should very deliberately and thoroughly advise a prospective debtor
client about the circumstances under which non-exempt assets can be transformed into
exempt assets with the least amount of risk that the transactions will be attacked by the
creditors. Unfortunately, the law does not provide clear guidance about the circumstances
under which such transfers are permitted so the attorney must be extremely careful in
recommending prepetition actions that are strictly prompted by the anticipated future filing
of a bankruptcy case. If the transfers are determined by the court to be done with the

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43 Sections 727 and 1141(d) of the Code; In re Rice, 109 B.R. 405 (Bankr. E.D. Cal. 1989).
deliberate intent to delay, hinder or defraud creditors, then the debtor’s discharge may be denied.\textsuperscript{44} To attempt to avoid claims that an attorney and debtor client sought to delay, hinder or defraud creditors through pre-bankruptcy conduct, I suggest the following:

1. Avoid transactions that form a pattern that might show a scheme to remove assets from the estate immediately prior to filing a bankruptcy petition (including conversion of a substantial amount of non-exempt assets to exempt assets);\textsuperscript{45}

2. Do nothing that would hide assets from creditors (including failure to make full disclosure in the schedules and statement of financial affairs and at the creditors’ meeting);

3. Do not recommend or acquiesce in any action to conceal transactions in which assets are transferred from the estate shortly before bankruptcy;

4. Do not ask creditors to forebear from collection efforts while non-exempt assets are being converted to exempt assets;

5. Ensure that assets are transferred for reasonably equivalent value;

6. Do not recommend or acquiesce to any substantial transaction between the debtor and relatives, insiders or affiliates, especially if there is not fair value given for the debtor’s assets;

7. Do not allow any communications to be sent to creditors that might be misleading or a misrepresentation, including bad faith promises to pay the debt in the future;

\textsuperscript{44} In re Bowyer, 916 F.2d 1056 (5th Cir. 1990) (pre-bankruptcy spending on travel and exempt assets was extrinsic evidence of intent to hinder and delay creditors and supported denial of discharge). But see In re Moreno, 892 F.2d 417 (5th Cir. 1990) (transfers permitted if for reason other than keeping assets from creditors).

\textsuperscript{45} See In re Reed, 700 F.2d 986 (5th Cir. 1983).
8. Do not permit transactions in violation of security agreements, including disposition of collateral without the consent of the secured creditor and do not use the proceeds from the sale of collateral contrary to the security agreement;

9. Do not borrow money to pay outstanding amounts owed with respect to which the collateral is an exempt asset;

10. Do not use business assets to pay personal debts; and

11. Avoid transfers that are not made in the ordinary course of business when the debtor is in financial trouble or contemplating filing a bankruptcy petition.

No actual harm to creditors need be shown for the bankruptcy court to deny discharge. In re Adeeb, 787 F.2d 1339, 1343 (9th Cir. 1986). In In re Bernard, 96 F.3d 1279 (9th Cir. 1996), prior to filing bankruptcy, the debtors withdrew funds from their bank accounts to prevent creditors from reaching them. The debtors argued that the amount of assets available in the bankruptcy estate was not reduced by the pre-bankruptcy withdrawals, but the Ninth Circuit found that “depletion of assets is not a prerequisite to denial of discharge....” Bernard, 96 F.3d at 1282. The Court focused on the behavior of the debtors rather than the net effect to the bankruptcy estate.

Because there is no bright-line test for determining whether a transfer made as part of pre-bankruptcy planning is either a violation of 18 U.S. C. § 152 or could be the basis for a non-discharge determination, the attorney for the prospective debtor must use restraint to not become overly aggressive in attempting to shield a client’s assets from creditor claims. Another concern an attorney should have relating to pre-bankruptcy planning is that if claims are later asserted against the client based on a suggestion or with the knowledge of an attorney, the client might contend the offensive conduct would not have been
undertaken but for the attorney’s advice. Although a client’s defense of “reliance on counsel” is somewhat limited in that (a) the reliance by the debtor must be reasonable and in good faith,\textsuperscript{46} and (b) the attorney must be fully aware of all relevant facts,\textsuperscript{47} an attorney should be aware that when a debtor is faced with the possibility of criminal liability or denial of discharge, the advice given by an attorney might be a convenient excuse for the debtor. To attempt to avoid baseless claims, an attorney giving pre-filing advice might consider having the client execute a memorandum acknowledging that (a) counseling has been given by the attorney about what may constitute criminal activity and improper transfers or other transactions, and (b) all of the debtor’s questions relating to such matters have been answered to the debtor’s satisfaction.

**Disinterestedness**

An attorney who is an “insider” or an “equity security holder” is not a “disinterested person” as that term is defined in Section 101(14) of the Bankruptcy Code. Under Section 327(a) of the Code a person must be disinterested to qualify to represent a debtor or trustee. Despite that prohibition, some courts have permitted an attorney to represent a debtor when the attorney owns only a nominal number of shares of a publicly traded debtor.\textsuperscript{48} Other courts have applied Section 101(14) strictly to preclude employment if any shares are owned.\textsuperscript{49} The disinterestedness standard has been strictly construed by many courts.

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courts,\textsuperscript{50} including the Fifth Circuit in \textit{In re Consolidated Bancshares}, 785 F.2d 1249, 1256 n.6 (5th Cir. 1986). Examples of grounds for disqualification of counsel for lack of disinterestedness include: holding prepetition secured or unsecured claims against the estate for unpaid fees,\textsuperscript{51} service as an officer of the corporate debtor,\textsuperscript{52} prior representation of the officers and directors of the debtor,\textsuperscript{53} and service as an escrow agent with respect to a transaction between the former corporate debtor and a creditor.\textsuperscript{54} Courts have even refused to permit an attorney from being employed as debtor’s counsel when the attorney merely served as secretary of the debtor corporation to assist in preparing documentation.\textsuperscript{55}

The standard relating to disinterestedness was the subject of a recommendation by the National Bankruptcy Review Commission ("NBRC") which issued its report on a number of bankruptcy issues in October 1997. Initially the NBRC recommended the removal of the disinterestedness requirement from the Bankruptcy Code resulting in a standard based only on whether the professional held an interest materially adverse to the bankruptcy estate. Shortly before the report was issued, the NBRC changed its recommendation substantially reducing the impact of the changes to the existing law. The recommendation submitted by the NBRC to Congress only suggested that the disinterestedness requirement not exclude professionals who had prepetition claims against the bankruptcy estate. The

\textsuperscript{50} Childress v. Middleton Arms, L.P. (\textit{In re Middleton Arms, Ltd. Partnership}), 934 F.2d 723, 725 (6th Cir. 1991); \textit{In re Envirodype Indus. Inc.}, 150 B.R. 1008, 1018 (Bankr. N.D. Ill. 1993).

\textsuperscript{51} \textit{In re Dansville Properties, Inc.}, 177 B.R. 174, 175 (Bankr. W.D. N.Y. 1995); \textit{In re CIC Inv. Corp.}, 175 B.R. 52, 56 (9th Cir. BAP 1994).


\textsuperscript{53} \textit{Universal C.I.T. Credit Corp. v. Grace (In re Tauber on Broadway, Inc.)}, 271 F.2d 766, 770 (7th Cir. 1959).

\textsuperscript{54} \textit{In re Classic Roadsters Ltd.}, 150 B.R. 751, 753 (Bankr. D. N.D. 1993).

failure of the NBRC to recommend more sweeping changes has been strongly criticized by members of the bankruptcy bar, especially attorneys who frequently represent debtors. Congress has not adopted any recommendations regarding disinterestedness and the current Code provisions relating to disinterestedness are still in effect.

An attorney may be permitted to represent a debtor if, after full disclosure of any facts which would have defeated disinterestedness status, the attorney takes curative action. For example, an attorney might sell shares in the debtor, withdraw from representing an affiliate, officer or director or resign from the board of directors. It may even be possible to resolve a disinterestedness issue based on an attorney being a creditor of the debtor or a transferee of a preferential transfer by the waiver of the claim or the return of the preference. If, however, the relationship that gave rise to the lack of disinterested status were too strong, the court may refuse to accept the attorney’s effort to cure the problem. Some courts have even allowed an attorney to represent a debtor while the attorney maintained a claim against the estate. The courts review the facts on an individual case basis and there is no well established rule regarding the effectiveness of any curative act.

59 In re Heatron, Inc., 5 B.R. 703 (Bankr. W.D. Mo. 1980) (attorney represented the debtor pre-bankruptcy, assisted in filing the Chapter 11 petition and was a major creditor, but was allowed to represent the debtor in possession to assist in the operation of the business although not disinterested); In re Best Western Heritage Inn Partnership, 79 B.R. 736 (Bankr. E.D. Tenn. 1987) (claim of attorney for fees for pre-petition services unrelated to preparation of Chapter 11 petition was not grounds for disqualification from representing the debtor in possession); In re Sharon Steel Corp., 154 B.R. 53 (W.D. Pa. 1993) (although accounting firm had an unsecured, non-priority claim and was not disinterested, court refused to apply a per se rule to disqualify the firm).
An attorney also has a duty to inform the court if he becomes disinterested during the course of the bankruptcy proceedings. In a recent case, a district court affirmed a bankruptcy court’s decision to deny all compensation to debtor’s counsel when he ceased to be disinterested during the course of the bankruptcy case. Debtor’s counsel represented both the Debtor and the Debtor’s sole principal and had filed a motion to assume and assign a lease from the Debtor to its sole principal at a price substantially below what Debtor’s counsel had several days earlier claimed was the market value of the lease. The bankruptcy court found that the Debtor’s counsel lost his disinterestedness status when he filed the motion to assume and assign and denied all legal fees incurred by Debtor’s counsel. If an attorney loses his disinterested status during the pendency of a bankruptcy case he should immediately bring it to the court’s attention. An attorney should also be aware of the risk to the payment of his fees if he takes any action that deprives him of his disinterested status.

**Potential Conflicts Within Law Firm**

An attorney who is considering accepting an engagement to represent a debtor must undertake a thorough investigation of potential conflicts arising from activities of other attorneys, legal assistants and even staff in the attorney’s law firm. The law is not settled about whether the disqualification of an attorney for lack of disinterestedness should be imputed to the entire firm. Although some courts have imputed disqualification, other judges have not reached such a conclusion. To attempt to ensure that the law firm is not

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60 In re Angelika Films 57th, Inc., 246 B.R. 176, 179 (S.D.N.Y. 2000).
62 In re Capen Wholesale, Inc., 184 B.R. 547 (E.D. Ill. 1995) (although a member of the law firm was formerly an assistant secretary of the debtor, the law firm was permitted to continue to represent its long standing client); In re Timber Creek, Inc., 187 B.R. 240, 242 (Bankr. W.D. Tenn. 1995) (lack of
tainted by the non-disinterested attorney, measures should be employed by the firm to insulate the attorney from any confidential information. The court in In re Timber Creek, 187 B.R. 240 (Bankr. W.D. Tenn. 1995) concluded that “screening mechanisms” and a “Chinese Wall” were sufficient to “quarantine” the law firm from the “infected” or “tainted’ attorney. If another attorney in the law firm serves as an officer, director or is an insider of the debtor or is a creditor, then the firm may be disqualified.\textsuperscript{63} There is no \textit{per se} rule. The court will determine whether a firm is disqualified based on the facts of the particular case.

**Failure to Disclose Assets and Other Improper Debtor Conduct**

In a chapter 11 case the principals of the debtor may give a higher priority to satisfying business demands that they believe are critical to keeping the operations viable or protecting their investment than to compliance with provisions of the Bankruptcy Code and fulfilling their fiduciary duty to the creditors. In some cases, the principals appear to consider the Code as only containing “technicalities” which can be ignored. Possibly they have not been educated sufficiently by their attorneys regarding the importance of complying with the Code but even if they have, their focus is sometimes only on the business. The demands of the Code only interfere with the company’s operations and, therefore, the principals of the debtor believe the legal requirements should be subordinated to business considerations. It is against that challenging backdrop that debtor’s counsel must function. Because of such dynamics there is constant tension between the client’s desire to conduct business as usual (of course while taking advantage of the automatic stay and other debtor-favoring provisions of the Code) and the efforts of

\textsuperscript{63} In re Tinley Plaza Associates, L.P., 142 B.R. 272 (Bankr. N.D. Ill. 1992) (firm disqualified from representing a debtor when a member of the firm served as president of a mortgage banking firm that financed the debtor post-petition).
debtor’s counsel to attempt to ensure compliance with the Code and Bankruptcy Rules. The attorney must be constantly vigilant to keep the debtor’s conduct within the dictates of the Code. The following are some of the more challenging areas for an attorney who may be under considerable pressure from a client to take liberties with requirements of the Code.

Soon after a bankruptcy petition is filed, a debtor has the obligation to file schedules of assets and liabilities, and a statement of financial affairs.\(^6^4\) These documents, which are Official Bankruptcy Forms, require extensive disclosure of financial information about the debtor, including transfers within 90 days of the commencement of the case. It is tempting for a debtor to “forget” to include assets, transfers or even liabilities. For example, a debtor might attempt to rationalize nondisclosure of an asset because it was “really meant to be” an asset of an affiliate or a third party. The definition of property of the estate is extremely broad\(^6^5\) and an attorney and debtor should consider including any assets on the schedules that arguably could fall within the definition. Knowingly filing a false (including incomplete) schedule or statement could also give rise to criminal liability pursuant to 18 U.S.C. § 152. An attorney for a debtor should read the “property of the estate” section of the Code (§ 541) to the debtor and discuss its breadth.

An attorney should admonish a client regarding the importance of complying with the requirement for full disclosure of information responsive to the questions in the schedules and statement of financial affairs, and should make reasonable efforts to ensure that correct and complete answers are made.\(^6^6\) Similarly, care should be taken with respect to the financial, business and other information required to be provided in a disclosure

\(^{6^4}\) Bankruptcy Rule 1007(b); Section 521 of the Code.

\(^{6^5}\) Section 541 of the Code.

statement filed in connection with a plan of reorganization.\textsuperscript{67} To attempt to ensure that the debtor has made proper disclosures, an attorney should be alert to questions by creditors at the first meeting of creditors and pleadings filed in the case that might indicate that the information provided by the debtor to creditors is incorrect or incomplete. These inquiries by creditors or other parties in interest can be sources of information that might prompt an attorney to probe disclosure issues with a debtor client. A debtor’s attorney should review the schedules and statement carefully after they have been completed by a client to ensure that the information is responsive to the questions and is consistent. If the responses are not, the attorney should discuss the problem areas with the client and work on the responses until they are correct.\textsuperscript{68} Even if information is corrected after a deficiency has been raised by a creditor, the debtor may be denied a discharge. At the least, the inadequate disclosure will damage the debtor’s credibility in the case. Try not to be put in the situation where you have to attempt to rehabilitate your client because of inadequate or incorrect disclosures.

If improper client conduct is discovered, the attorney should advise the client to take immediate corrective action and remind the client that the possible consequences of such conduct includes the inability to receive a discharge and possibly criminal liability. A client should also be advised that the attorney-client privilege does not preclude disclosure by the


attorney of information about illegal activity\textsuperscript{69} and that the attorney may be compelled to turn over books and records.\textsuperscript{70}

If after counseling with the attorney, the client refuses to disclose the information required by the Code or otherwise comply with its provisions or the debtor’s fiduciary duties, the attorney, if confident that improper conduct has occurred, should withdraw from the representation after obtaining leave of the court.\textsuperscript{71} Merely by seeking permission to withdraw from the representation the attorney may provide notice to the court and creditors regarding the conduct of the debtor sufficient to prompt an investigation of the debtor’s activities.\textsuperscript{72} The attorney may be sanctioned for failing to withdraw after the attorney becomes aware of the client’s improper conduct.\textsuperscript{73} An attorney would be in violation of an ethical duty if she knowingly cooperates actively or passively in conduct that defrauds or otherwise harms a creditor, including participating in a disclosure that was untrue or which failed to disclose a material fact. While an attorney in a bankruptcy case should maintain client confidences, she must not condone client illegality.

Some bankruptcy courts have even compelled an attorney to disclose information to the court about a client’s improper or illegal activities.\textsuperscript{74} Western District of Texas

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\item United States v. Ballard, 779 F.2d 287, 292-93 (5th Cir.) cert. denied, 475 U.S. 1109, 106 S. Ct. 1518, 89 L.Ed. 2d 916 (1986).
\item Section 542(e) of the Bankruptcy Code authorizes the court to order an attorney to turn over or disclose to the trustee documents relating to the debtor’s property or financial affairs. This authority is subject to “any applicable privilege.”
\item In re Wilde Horse Enterprises, Inc, 136 B.R. 830 (Bankr. C.D. Cal. 1991).
\item In re Matthews, 154 B.R. 673, 680 (Bankr. W.D. Tex. 1993).
\item In re Huerta, 137 B. R. 356, 378-79 n.8 (Bankr. C.D. Cal. 1992).
\item In re Rivers, 167 B.R. 288, 300 (Bankr. N.D. Ga. 1991) (if reorganization impossible, attorney should so advise the U.S. Trustee and the court); In re United Utensils Corp, 141 B.R. 306, 309 (Bankr. W.D. Pa. 1992) (“If the debtor is not fulfilling its fiduciary obligations to the estate, it is the responsibility and duty of Debtor’s counsel to bring such matters to the attention of the Court.”) (cited with approval in In re Barrie Reed Buick-GMC, Inc., 164 B.R. 378, 381 (Bankr. S.D. Fla. 1994)); In re Wilde Horse Enterprises, Inc., 136 B.R. 830, 847 (Bankr. C.D. Cal. 1991) (if counsel is “ethically uncomfortable” she should bring the matter to the court’s attention by motion to withdraw “or in some other way,” otherwise to
\end{itemize}
Bankruptcy Judge Clark, citing In re Saturley, 131 B.R. 509, 519 (Bankr. D. Mass. 1991), suggested that if an attorney in a bankruptcy case believes that the client has not been truthful in a representation in the case, the attorney “could alert the U.S. Trustee, the court, or another interested party that, despite the attorney’s best efforts, the schedules are incomplete or inaccurate” or request permission to withdraw from the representation.\textsuperscript{75} If withdrawal is necessary, the attorney must do so in a manner that will harm the client as little as reasonably possible.\textsuperscript{76} The withdrawing attorney should protect the client’s interests, give as much notice as possible, turn over documents and property and refund any unearned portion of a retainer.

District Judge Werlin issued an opinion (In re Gregory, 214 B.R. 570 (S.D. Tex. 1997)) affirming an order requiring a bankruptcy attorney to disgorge fees because of the counsel’s failure to disclose improper conduct of a debtor. The debtor had dissipated funds that were, pursuant to court order, to be deposited in a segregated account for potential distribution to a creditor. Although bankruptcy counsel became aware of conduct in violation of the order, he “failed for well over a year to advise the Bankruptcy Court that the funds were missing.” Id. at 573. Judge Werlin noted that

“[t]he attorney for the debtor-in-possession also has a duty as the fiduciary of the estate and cannot close his eyes when the debtor is behaving in a manner contrary to the best interests of the estate and is disregarding orders of the bankruptcy court.”

Id. at 575, 576.

\textsuperscript{75} In re Matthews, 154 B.R. 673, 681 (Bankr. W.D. Tex. 1993); Texas Rule 1.15(b)(2)(B).
\textsuperscript{76} Texas Rule 1.15 (d); ABA Rule 1.16.
As if the loss of fees were not enough, the bankruptcy court referred the attorney to the State Bar of Texas for potential disciplinary action. The District Court held that such a referral was not a judicial act that was subject to appellate review but was an act as a judicial officer and citizen. Gregory is a clear message to attorneys representing debtors that the attorneys’ responsibilities, loyalty and duties do not run solely to the client.

**Sanctions for Ethical Violations**

Bankruptcy courts have ordered a variety of sanctions to punish ethical, quasi-ethical or disclosure violations by attorneys. Most frequently a court will, in essence, levy a fine against an attorney for a debtor, trustee or committee if the court concludes that there has been an ethical breach, including inadequate disclosure. The “fine” is in the form of a reduction or even complete disallowance of the professional’s compensation.\(^{77}\) Sanctions for non-disclosure are appropriate even if there has been no harm to the estate or creditors.\(^{78}\) It is clearly proper for a court to consider unethical, improper or deficient conduct when evaluating the amount of fees that will be allowed to an attorney who has been approved by the court to represent a debtor, trustee or creditors’ committee.\(^{79}\)


\(^{79}\) In re Kendavis International, Inc., 91 B.R. 742, 748 (Bankr. N.D. Tex. 1988); In Re Coastal Equities, Inc., 39 B.R. 304, 312 (Bankr. S.D. Cal. 1984); In re Amdura Corp., 139 B.R. 963 (Bankr. D. Colo. 1992) (sanction for failure to disclose potential conflict based on prior representation was denial of all fees); In re Engel, 246 B.R. 784 (Bankr. M.D.Pa. 2000) (sanction against attorney for debtor’s failure to disclose asset and debtor’s undervaluation of asset on debtor’s schedule of assets and liabilities and schedule of financial affairs).
When a compensation based penalty is not available or would be inappropriate, the court may levy an actual fine.\textsuperscript{80} Another form of satisfaction is to disqualify the attorney from further representation of the debtor, trustee, or committee.\textsuperscript{81} An attorney may even be suspended from practice before the bankruptcy court as a sanction for an ethical or disclosure violation in a bankruptcy case. In \textit{In re Rusty Jones, Inc.}, 134 B.R. 321 (Bankr. N.D. Ill. 1991), for failure to disclose a former relationship that was adverse to the estate, an attorney for a debtor was suspended from the practice of law and the law firm was denied some of the compensation it sought. Criminal penalties for violating Section 152 of title 18 are a fine and/or incarceration of up to 5 years. Clearly an attorney who steps over the ethical boundaries in a bankruptcy case may suffer more than professional embarrassment.\textsuperscript{82}

\section*{Practice Suggestions}

Although these materials have included several practice suggestions, set forth below are additional comments regarding ethics related matters about which the bankruptcy court practitioner should be knowledgeable.

- Ensure that you have sufficient expertise in the Bankruptcy Code and Rules before you accept the engagement. This is particularly important if your client will be the debtor. On the job education and training can be dangerous for your client and you. If you accept an engagement, at least get assistance from an experienced bankruptcy practitioner. There are many potential pitfalls which can be expensive to

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    \item \textsuperscript{80} \textit{In re Malmen}, 140 B.R. 819 (Bankr. M.D. Fla. 1992) (attorney for Chapter 13 debtor fined $20,000 for abusing the bankruptcy system and violating Rule 4-1.7(b) of the Florida Rules of Professional Conduct).
    \item \textsuperscript{81} \textit{In re Guy Apple Masonry}, 45 B.R. 1609 168 (Bankr. D. Ariz. 1984) (a violation of a state disciplinary rule was the basis for disqualification).
    \item \textsuperscript{82} \textit{U.S. v. Gellene}, 182 F.3d 578, 581 (7th Cir. 1999)(attorney sentenced to 15 months imprisonment on each count to run concurrently for violations of 18 U.S.C. sections 152 & 1623 and fined $15,000.00).
\end{itemize}
an attorney and could even expose the attorney to criminal liability. Remember, mistakes in a bankruptcy case not only affect your client but the estate and the creditors.

- Make sure you know who you are representing. If the client/debtor is a business entity, your professional loyalties must be to that entity and not to principals, insiders or affiliates. Advise the senior officers and the directors about your duties to the client/debtor as distinguished from the individuals who control or own the debtor.

- Do not represent more than one client in a case if one of those clients would be the debtor, the trustee or the creditors’ committee. An attorney may be able to represent multiple creditors but be sure they understand the potential conflicts. File a statement pursuant to Rule 2019 if you have more than one creditor client.

- At the outset of a debtor representation, counsel with your client about the Bankruptcy Code and Bankruptcy Rule requirements, including disclosure obligations and the debtor’s fiduciary duties to creditors. The persons responsible for the management of the debtor must be aware of their primary obligation to act in the best interests of the estate even if such conduct is contrary to the interests of the insiders and shareholders or even what they might think is good for the business operations.

- Thoroughly investigate all possible conflicts of interest and potential areas of nondisinterestedness. Disclose to the court and the creditors in the employment application all relevant information and supplement the application if necessary during the case.

- Ensure that the schedules and statement of financial affairs are complete and the information, including the estimated values of assets, is correct. Read the
schedules and statement of financial affairs carefully so you and your client understand the information being requested. The answers must be consistent and complete. Do not play lawyer word games. Err on the side of over disclosure.

- Review with your client the criminal statutes applicable to parties involved in a bankruptcy case. Be sure the client understands the prohibited conduct and the potential penalties for a violation. Possibly request the client to sign a memorandum that the debtor’s representative has read the criminal statutes, discussed them with you and understands what they mean.

- Advise a debtor client that you will withdraw from the representation if the client refuses to comply with the requirements of the Code and Rules, fails to disclose information to which the court and creditors are entitled, acts in a manner inconsistent with its fiduciary obligations or participates in any fraudulent, improper or unethical conduct. The client should also be aware of the attorney’s duties to the court and possibly to the United States Trustee and the creditors regarding disclosure of improper conduct.

- Monitor the debtor’s business conduct. Manipulation of the assets by the debtor, such as making fraudulent payments to insiders or preferential payments to certain creditors to reduce the personal financial exposure of the debtor’s principals might lead to a penalty against the debtor’s attorney. Although an attorney is not expected to supervise the daily operations of a debtor, a debtor’s attorney may be sanctioned if she fails to take appropriate corrective action after becoming aware of improper conduct by the debtor client.

- An attorney should never attempt to take advantage of her status in a bankruptcy case. For example, an attorney for any party involved in a bankruptcy case should
not purchase any asset from the estate. Any conduct by an attorney for her own benefit at the expense of the creditors will be subject to a severe penalty.

- Comply with Local Bankruptcy Rule 2016 of the Rules of the United States Bankruptcy Court for the Northern District of Texas regarding disclosure and disposition of retainer fees.

- If it is apparent that your debtor client will not follow your advice regarding compliance with the Code and Rules, withdraw from the engagement. The longer an attorney tolerates such conduct the greater her exposure to sanctions.

**Conclusion**

If an attorney is sensitive to the special relationships that exist in a bankruptcy case ethical problems can be avoided. A bankruptcy case is **not** the same type of a legal proceeding as a lawsuit. Fiduciary duties are assumed by many parties and the attorneys representing those parties have unique obligations because of such duties. An attorney for the debtor must be particularly vigilant to spot questionable conduct by a client and such conduct should be corrected immediately. An attorney must accept an engagement to represent a debtor, trustee or creditors’ committee with the understanding that the services will be scrutinized by the court, the United States Trustee and the creditors. A knowledgeable and careful federal court practitioner should be able to practice ethically in a bankruptcy case environment if the attorney knows the applicable statutes and rules, and understands that the obligations are not that of merely an aggressive advocate.