CLE Track

An Attorney's Ethical Duty to Disclose Confidential Information to Creditors of an Insolvent Client (Op. 603 (2010), 74 Tex. B.J. 74 (2011)): Did the Texas Ethics Committee Get It Right?

Demetra L. Liggins, Moderator
Thompson & Knight LLP; Houston

E. Paul Keiffer
Wright Ginsberg Brusilow P.C.; Dallas

Hon. Ronald B. King
U.S. Bankruptcy Court (W.D. Tex.); San Antonio

Leslie M. Luttrell
Luttrell + Villarreal Law Group; San Antonio

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF TEXAS
TYLER DIVISION

LBDS HOLDING COMPANY, LLC, Plaintiff, v. ISOL TECHNOLOGY INC., MEDIVALLEY INC., HEUNG-KYU LEE, Defendants.	§ § § § § § § § § § §	Civil Action No. 6:11-cv-00428-LED **JURY TRIAL DEMANDED**

NOTICE TO COURT PURSUANT TO TEXAS DISCIPLINARY RULE OF PROFESSIONAL CONDUCT 3.03 AND UNOPPOSED MOTION TO WITHDRAW AS COUNSEL FOR PLAINTIFF

Akin Gump Strauss Hauer & Feld LLP and attorneys Sanford E. Warren, Jr., Lisa S. Gallerano, Ronald Scott Rhoades, Joshua L. Hedrick, Steven Udick, Charles Everingham IV, and James L. Duncan, III (collectively, "Akin Gump") respectfully provide notice to this Court pursuant to Texas Disciplinary Rule of Professional Conduct 3.03 and ask the Court to allow Akin Gump to withdraw as counsel for Plaintiff LBDS Holding Company, LLC ("LBDS"). Akin Gump recognizes that the timing of its request is unusual, coming as it does after the rendering of a jury verdict in favor of Plaintiff, and while a Motion for Entry of Judgment is pending. However, under the circumstances discussed below, withdrawal is fully justified.

Factual Background

On May 14, 2014, Defendants' counsel served an Emergency Motion for Sanctions against LBDS under Rule 11 (the "Motion," which Defendants' counsel has represented will be

filed in this Court today) setting forth certain allegations about Plaintiff.[1] Defendants allege that LBDS and its principals manufactured and falsified evidence used in this litigation, testified falsely, and committed a fraud upon this Court. Defendants claim Plaintiff's actions tainted this lawsuit and require this Court to set aside the verdict entered against ISOL Technology, Inc. in this case. In accordance with the safe-harbor provision of Rule 11, Defendants afforded Plaintiff an opportunity to review and respond to the allegations in the Motion before filing it with this Court.

Akin Gump reacted swiftly to the allegations in Defendants' Motion. Akin Gump immediately forwarded the Motion to representatives of LBDS and attempted to set up a teleconference to discuss the claims made in that Motion.[2] After several unsuccessful efforts to speak with Plaintiff on May 14, 2014, Akin Gump partner Sanford Warren participated in a teleconference with LBDS principal (and trial witness) Bert Davis on May 15, 2014.[3] Mr. Davis was the only person who spoke to Mr. Warren during the call, although Mr. Davis represented to Mr. Warren that LBDS principals Suresh Reddy, David Tayce, and former principal (and trial witness) Dave Hernon were on that call.[4] Mr. Davis told Mr. Warren that the allegations in the Motion were "essentially correct."[5] Specifically, Mr. Davis told Mr. Warren that the "Cerner contract," upon which Plaintiff relied at trial, was not authentic.[6] According to Mr. Davis, although there had been an actual contract with Cerner Corporation, that contract had been altered and had certain schedules attached to it which were forgeries.[7] Further, Mr. Davis said

[1] Decl. of Sanford E. Warren, Jr. ("Sanford Decl.) ¶ 3, attached hereto as Exhibit "A."
[2] *Id*. ¶ 5.
[3] *Id*. ¶ 6.
[4] *Id*. ¶¶ 6-7.
[5] *Id*. ¶ 7.
[6] *Id*. ¶ 8.
[7] *Id*.

that those on the call had set up a fictitious domain name and sent emails from that domain name to create the impression that certain emails, introduced into evidence at the trial of this case, were sent by Cerner Corporation, when in fact they were not.[8] Mr. Davis told Mr. Warren that these activities began in 2009 during a period of negotiations between Plaintiff and ISOL.[9] Neither Mr. Reddy, nor Mr. Tayce, nor Mr. Hernon said anything to deny the statements being made by Mr. Davis to Mr. Warren.[10]

In light of these statements, Mr. Warren informed Mr. Davis, Mr. Reddy, Mr. Tayce and Mr. Hernon during the May 15, 2014 teleconference and again by letter sent the next day, May 16, 2014, that the Texas Disciplinary Rules of Professional Conduct[11] require Akin Gump to call upon each of them, and through them, the Plaintiff, to disclose to this Court the information Mr. Davis revealed to Mr. Warren during the May 15th teleconference.[12] Mr. Warren also advised those on the call orally and through the May 16th letter that, should Plaintiff not promptly disclose this information to the Court, Akin Gump would do so in accordance with the Texas Disciplinary Rules of Professional Conduct.[13] Mr. Warren further informed all on the call that, in light of Mr. Davis' statement that the allegations in the Motion were "essentially correct," Akin Gump could no longer represent Plaintiff in this matter.[14]

Before May 15, 2014, Akin Gump did not know the contract and documents provided by Plaintiff and entered into evidence in this litigation were forgeries and falsifications.[15] Nor did

[8] *Id*. ¶ 9.

[9] *Id*. ¶ 10.

[10] *Id*. ¶ 11.

[11] This Court's Local Rule AT-2 provides that the standards of professional conduct adopted as part of the Rules Governing the State Bar of Texas serve as a guide governing the obligations and responsibilities of all attorneys appearing in this court.

[12] Warren Decl. ¶¶ 12-13.

[13] *Id*.

[14] *Id*.

[15] *Id*. ¶ 14.

Akin Gump, prior to May 14, 2014, have any reason to question the authenticity of the documents at issue.[16] Finally, Akin Gump did not know that any of the testimony offered by Messrs. Davis or Herndon was untrue.[17]

Argument and Authorities

The Texas Disciplinary Rules of Professional Conduct obligate Akin Gump to take measures to remediate Plaintiff's false testimony and disclose Plaintiff's deception to this Court. These circumstances also permit Akin Gump to withdraw as counsel for LBDS in this proceeding.

A. Akin Gump's Duty of Candor to the Court Requires Akin Gump to Disclose Plaintiff's Deception.

Akin Gump now knows that it offered false evidence and testimony into the record of this litigation. Texas Disciplinary Rule of Professional Conduct 3.03, Candor Toward the Tribunal, requires Akin Gump to take remedial measures, including disclosing LBDS' deception to the Court. Rule 3.03 provides:

> If a lawyer has offered material evidence and comes to know of its falsity, the lawyer shall make a good faith effort to persuade the client to authorize the lawyer to correct or withdraw the false evidence. If such efforts are unsuccessful, the lawyer shall take reasonable remedial measures, including disclosure of the true facts.

Tex. Disciplinary Rules Prof'l Conduct 3.03(b).

Akin Gump tried to persuade LBDS to correct or withdraw the false evidence in this litigation during the May 15th teleconference and via letter dated May 16, 2014. LBDS has not done so. The Texas Disciplinary Rules of Professional Conduct therefore call upon Akin Gump to disclose the existence of this deception to the Court. *See* Tex. Comm. on Prof'l Ethics, Op. 480, V. 56 Tex. B.J. 705 (1993) (opining that an attorney was required to make a good faith effort

[16] *Id.* ¶ 15.
[17] *Id.* ¶ 16.

to persuade his former client to disclose to a bankruptcy court that certain settlement funds had been directed to a Trust, and not to another creditor as stated previously to the court, and also directing the attorney to disclose that fact to the bankruptcy court without the former client's consent if the lawyers efforts were unsuccessful); *see also* Tex. Disciplinary Rules Prof'l Conduct 1.05(f) ("A lawyer shall reveal confidential information when required to do so by … Rule 3.03(b) …"); *id*. at 1.05(c)(8) (permitting a lawyer to reveal confidential information "to the extent revelation reasonably appears necessary to rectify the consequences of a client's criminal or fraudulent act in the commission of which the lawyer's services had been used.").

B. Texas Disciplinary Rules of Professional Conduct Permit Akin Gump's Withdrawal as Counsel for LBDS.

The Texas Disciplinary Rules of Professional Conduct permit Akin Gump to withdraw as counsel for LBDS. LBDS forged documents produced in this litigation, verified those documents, and through its counsel, introduced those documents into evidence in the trial of this case. They also testified falsely to mislead this Court and the jury. In other words, LBDS used Akin Gump's services as counsel to perpetrate a fraud on this Court. Texas Disciplinary Rule of Professional Conduct 1.15(b)(3) permits withdrawal when "the client has used the lawyer's services to perpetrate a … fraud." *See Hovious v. Hovious*, No. 2-04-169-CV, 2005 WL 555219, at *2-3 (Tex.App.—Fort Worth Mar. 10, 2005, pet. denied) Withdrawal under Rule 1.15(b)(3) is allowed "even though the withdrawal may have a material adverse effect upon the interest of the client." Tex. Disciplinary Rule of Prof'l Conduct 1.15 cmt. 8.

Second, based on the facts in the Motion and subsequent conversation with counsel for Defendants, in addition to the investigation this Court will likely conduct into this matter, it appears that the United States Department of Justice and the Federal Bureau of Investigation are investigating this litigation. Indeed, the Motion attaches a subpoena to defense counsel to testify

before a Grand Jury convened by the United States District Court for the Western District of Missouri, which commands defense counsel to provide copies of a number of documents from this trial, including the trial transcript and any trial exhibits admitted during trial. Akin Gump does not know whether that Grand Jury's investigation relates only to this litigation or is broader in scope.

Texas Disciplinary Rule of Professional Conduct 3.08(b) provides that a lawyer "shall not continue as an advocate" in a pending proceeding "if the lawyer believes that the lawyer will be compelled to furnish testimony that will be substantially adverse to the lawyer's client …" Akin Gump believes that its lawyers may be compelled to testify adversely to LBDS—either in this Court or before the Grand Jury in Missouri—triggering the requirement that Akin Gump withdraw as counsel. Rule 1.15(a)(1) provides that a lawyer "shall withdraw … from the representation of a client if (1) the representation will result in violation of Rule 3.08, other applicable rules of professional conduct or other law …" The rules therefore require Akin Gump to withdraw as LBDS' counsel.

Finally, withdrawal should be permitted because a conflict of interest exists between Akin Gump and LBDS. Texas Disciplinary Rule of Professional Conduct 1.06, Conflict of Interest, provides:

> A lawyer shall not represent a person if the representation of that person … reasonably appears to be or become adversely limited by the lawyers or law firm's responsibilities … to a third person or by the lawyers or law firm's own interests.

Tex. Disciplinary Rule of Prof'l Conduct 1.06(b)(2). Akin Gump's representation of LBDS is "adversely limited" by Akin Gump's own interests and obligations to follow the Texas Disciplinary Rules of Professional Conduct. Rule 1.15(a)(1), which obligates a lawyer to "withdraw .. from the representation of a client, if the representation will result in violation of

Rule 3.08, other applicable rules of professional conduct or other law," compels Akin Gump to withdraw as counsel for LBDS.

Based upon the foregoing and with agreement of the Defendants, Akin Gump Strauss Hauer & Feld LLP respectfully requests that the Court allow it to withdraw as counsel for LBDS.

Dated: May 21, 2014

Respectfully submitted,

By: */s/ Sanford E. Warren, Jr.*

Sanford E. Warren, Jr. (Lead Attorney)
State Bar No. 20888690
swarren@akingump.com
Lisa S. Gallerano (State Bar No. 07589500)
lgallerano@akingump.com
Ronald Scott Rhoades (State Bar No. 90001757)
srhoades@akingump.com
Joshua L. Hedrick (State Bar No. 24061123)
jhedrick@akingump.com
Steven Udick (State Bar No. 24079884)
sjudick@akingump.com
AKIN GUMP STRAUSS HAUER & FELD LLP
1700 Pacific Avenue, Suite 4100
Dallas, Texas 75201
Telephone: 214.969.2800
Facsimile: 214.969.4343

Charles Everingham, IV (State Bar No. 00787447)
ceveringham@akingump.com
AKIN GUMP STRAUSS HAUER & FELD LLP
911 West Loop 281
Longview, Texas 75604
Telephone: 903.297.7404
Facsimile: 903.297.7402

James L. Duncan, III (State Bar No. 24059700)
jduncan@akingump.com
AKIN GUMP STRAUSS HAUER & FELD LLP
1111 Louisiana Street, 44th Floor
Houston, Texas 77002
Telephone: 713.250.2227
Facsimile: 713.236.0822

ATTORNEYS FOR PLAINTIFF
LBDS HOLDING COMPANY, LLC

CERTIFICATE OF CONFERENCE

The undersigned certifies that, on May 16, 2014, Akin Gump met and conferred with Jim [James?] Walker, counsel for Defendants, and that Defendants have advised that they are not opposed to the withdrawal of current counsel.

/s/ Sanford E. Warren, Jr.
Sanford E. Warren, Jr.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that all counsel of record who are deemed to have consented to electronic service are being served this 21st day of May 2014, with a copy of the foregoing document via the Court's CM/ECF system pursuant to Local Rule CV-5(a)(3). Mr. Davis, as representative of LBDS, and any other counsel of record will be served by email and/or first class mail.

/s/ Sanford E. Warren, Jr.
Sanford E. Warren, Jr.

EXHIBIT A

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF TEXAS
TYLER DIVISION

LBDS HOLDING COMPANY, LLC,	§	
	§	
Plaintiff,	§	
	§	Civil Action No. 6:11-cv-00428-LED
v.	§	
	§	
ISOL TECHNOLOGY INC.,	§	**JURY TRIAL DEMANDED**
MEDIVALLEY INC.,	§	
HEUNG-KYU LEE,	§	
	§	
Defendants.	§	

DECLARATION OF SANFORD E. WARREN, JR.

1. My name is Sanford E. Warren, Jr. I am over 18 years of age, of sound mind, and capable of making this declaration. The facts stated in this declaration are within my personal knowledge and are true and correct.

2. I am a Partner at Akin Gump Strauss Hauer & Feld LLP ("Akin Gump"). I was the Lead Attorney representing Plaintiff LBDS Holding Company, LLC ("LBDS") during trial of this matter.

3. On May 14, 2014, Defendants in this litigation served an Emergency Motion for Sanctions on me as counsel for LBDS (the "Motion").

4. Akin Gump's Notice to Court Pursuant to Texas Disciplinary Rule of Professional Conduct 3.03 and Unopposed Motion to Withdraw as Counsel for Plaintiff summarizes the allegations made in the Motion.

5. After reviewing the Motion, I attempted to speak with LBDS principals and former principals on May 14, 2014.

6. On May 15, 2014 I participated in a teleconference with LBDS principal and trial witness Bert Davis. Mr. Davis represented that LBDS principals Suresh Reddy, David Tayce, and former principal (and trial witness) David Hernon were on the call.

7. Mr. Davis was the only person of the four LBDS representatives who spoke during the teleconference. During the call, Mr. Davis told me that the allegations in the Motion were "essentially correct."

8. Specifically, Mr. Davis told me that the "Cerner contract" was not authentic. Mr. Davis stated that although there had been an actual contract with Cerner Corporation, that contract had been altered and had certain schedules attached to it that were forgeries.

9. Further, Mr. Davis said that the LBDS representatives on the call had set up a fictitious domain name and sent emails from that domain name to create the impression that certain emails were sent by Cerner Corporation, when in fact they were not.

10. Mr. Davis told me that these activities began in 2009 during a period of negotiations between Plaintiff and ISOL.

11. Neither Mr. Reddy, nor Mr. Tayce, nor Mr. Hernon said anything to deny the statements Mr. Davis made to me.

12. During that call, I told the participants that Akin Gump could no longer represent LBDS in this matter.

13. I repeated this information in a letter sent to LBDS on May 16, 2014, which also informed LBDS that the Texas Disciplinary Rules of Professional Conduct require Akin Gump to call upon LBDS to disclose to this Court the information they revealed to me during the May 15, 2014 teleconference and that, should Plaintiff not promptly disclose this information to the Court, Akin Gump would do so.

14. Before May 15, 2014, I did not know the contract and documents provided by Plaintiff and entered into evidence in this litigation were forgeries and falsifications.

15. Nor did I, prior to May 14, 2014, have any reason to question the authenticity of the documents at issue.

16. Nor did I, prior to May 15, 2014, know that any of the testimony offered by Mr. Davis or Mr. Herndon was untrue.

I declare under penalties of perjury that the foregoing is true and correct.

SANFORD E. WARREN, JR.

Duty of Lawyers Representing Insolvent Debtors to Disclose Confidential Information to Creditors

Written by:
Frank L. Broyles
Goins, Underkofler, Crawford & Langdon LLP
Dallas
frankb@gucl.com

An attorney representing a client in a chapter 11 debtor-in-possession case, especially if the client is closely held, can encounter significant ethical dilemmas stemming from conflicts between the personal interests of the client representative and that representative's fiduciary obligations to the client or its creditors.[1] The dilemma results from a lawyer's competing duty of confidentiality on one hand and the lawyer's duty of disclosure on the other hand in situations where management misconduct might constitute a fraud or crime, a dilemma that Maryland's highest court termed a "legal ethics nightmare."[2]


Frank L. Broyles

The problem was recently considered by the Professional Ethics Committee for the State Bar of Texas in Ethics Opinion 603.[3] The committee addressed the obligation of an attorney representing an insolvent, closely-held corporation to disclose, or not disclose, confidential information to the creditors of that corporation. The committee framed the specific question before it as follows:

> Do the Texas Disciplinary Rules of Professional Conduct require or permit a lawyer to reveal to [an insolvent] corporation's creditors the lawyer's advice to the corporation that the person who owns and manages the corporation has engaged in conduct that constitutes a breach of the person's fiduciary duties to the corporation?[4]

This article discusses the committee's analysis, significant distinctions between the relevant ABA Model Rules and the Texas Rules, and difficulties that an attorney representing an insolvent debtor may face when confronted with this "legal ethics nightmare."

About the Author

Frank Broyles is a partner of Goins, Underkofler, Crawford & Langdon LLP in Dallas and is board certified in business bankruptcy law by the Texas Board of Legal Specialization.

The Committee's Analysis

Factual Background

The committee identified the following six situational conditions material to its opinion:

1. A single individual controls the ownership and management of the corporation;
2. The corporation is insolvent;
3. The lawyer representing the corporation has concluded that the managing individual is engaging in conduct in breach of his or her fiduciary duties to the corporation;
4. The offensive conduct is likely to cause significant harm to the corporation's creditors;
5. The attorney has advised the managing individual that his or her conduct is in breach of his or her fiduciary duties to the corporation and should be stopped; and
6. The managing individual disregards the advice and specifically instructs the attorney not to make disclosure to the corporation's creditors.

Cornerstone Obligation of Confidentiality

The committee initially emphasized the fundamental obligation of an attorney to preserve "confidential information" and supported it by quoting from Comment 1 to Disciplinary Rule 1.05(b) as follows:

> "Both the fiduciary relationship existing between the lawyer and client and the proper functioning of the legal system require the preservation by the lawyer of confidential information of one who has employed or sought to employ the lawyer." Comment 1 to Rule 1.05 of the Texas Disciplinary Rules of Professional Conduct. Conclusions reached by a lawyer regarding the conduct of a corporate client's representative and the resulting advice that the lawyer gives to the corporation are "confidential information" as defined in Rule 1.05d(a).[5]

Exceptions to the Obligation of Confidentiality

After emphasizing the duty to preserve client confidentiality, the committee considered the confidentiality exceptions provided in Rule 1.05. It first noted the obvious inapplicability of the *mandatory disclosure* exception provided in Disciplinary Rule 1.05(e), which requires disclosure to the extent necessary to prevent the client's applicable criminal or fraudulent acts when such acts are likely to result in death or substantial bodily harm. The committee next addressed the *permissive disclosure* exceptions to confidentiality, focusing on the exception provided in Rule 1.05(c)(7), which reads in pertinent part:

> [A] lawyer may reveal a client's confidential information "[w]hen the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or [actual] fraudulent act."[6]

Critical to the committee's analysis is whether management's breach of fiduciary duty constituted actual (*i.e.*, deceptive) fraud as opposed to constructive fraud. If actual deception is not present, the committee concluded that "*nothing*

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Feature

1 The scope of the duty owed by fiduciaries of an insolvent entity to that entity's creditors is not cut-and-dried. The law of the state under which the entity was chartered will typically control irrespective of the law of the forum state. Under both Texas and Delaware law, there is substantial authority that insolvency creates a fiduciary duty owed by management to creditors. *Carrieri v. Jobs.com Inc.*, 393 F.3d 508, 534 n. 24 (5th Cir. 2004); *Weaver v. Kellogg*, 216 B.R. 563, 584 (S.D. Tex. 1997). *But see Millbank v. Holmes (In re TOCFHBI Inc.)*, 413 B.R. 523, 539 (Bankr. N.D. Tex. 2009), in which the bankruptcy court clarified that under either Texas or Delaware law, no fiduciary duty is owed by the managers of an insolvent entity directly to creditors, but rather the duty is owed to the corporation.

2 *Attorney Grievance Commission of Maryland v. Rohrback*, 591 A.2d 488, 489 (Md. 1991). Examples in the bankruptcy context concern management decisions pertaining to claims by and against insiders, such as management's refusal to pursue significant avoidance claims under 11 U.S.C. §§ 547 or 548.

3 Tex. Comm. on Prof'l Ethics, Op. 603, 74 Tex. B. J. 74 (2010).

4 Id. at 74.

5 Id.

6 Id.

Duty of Lawyers to Disclose Confidential Information to Creditors

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in the Texas Disciplinary Rules would authorize the lawyer to reveal the lawyer's conclusions and advice to the corporation's creditors."[7]

Committee's Ultimate Conclusion

In the end, the committee concluded that an attorney is never required to disclose confidential information to creditors but, under the facts presented, may make such disclosure if (1) management's breaches of fiduciary duty would cause the corporation to engage in actual fraud, (2) the actual fraud would likely result in substantial financial harm to the creditors, (3) the lawyer has attempted, unsuccessfully, to dissuade management from committing the fraud, (4) the lawyer believes disclosure to the creditors will prevent the fraud and (5) the lawyer believes no less-drastic action will prevent the fraud. If any one of these five factors is missing, the committee concluded, disclosure would violate the attorney's obligation of confidentiality.

Resolution of "Legal Ethics Nightmare": Practical Problems

Two assumptions by the committee limit practical application of the opinion: the assumption that the client representative's offensive conduct was not likely to cause any material harm to the corporation because the corporation was insolvent, and the assumption that under the facts presented, none of the mandatory disclosure provisions of Rule of Professional Conduct 1.05(f) applied.

With respect to the first assumption, it is not necessarily true that an insolvent corporation cannot suffer damages resulting from breaches of fiduciary duty by one of its managers. For example, a fundamental purpose of reorganizational chapter 11 plans is the preservation of the debtor's going-concern value, and that value could be significantly damaged or destroyed as a result of management's breaches of their fiduciary duties.

Damage to the "client" entity, as opposed to damage only to third parties, such as creditors, implicates Texas Rule 1.12(b), which *requires* the lawyer to take reasonable remedial actions if the lawyer learns that an agent of his or her client has committed or intends to commit either a violation of a legal obligation to the client or a violation of a law that reasonably might be imputed to the client if the violation is likely to result in substantial injury to the client.

The remedial actions contemplated by Rule 1.12(b) are not restricted to actions internal to the client organization. Indeed, Comment 7 to Rules 1.12 and 1.12(c) both refer specifically to an attorney's duty to reveal information to persons outside the organization. Comment 7 reads, in relevant part:

> The ultimate and difficult ethical question is whether the lawyer should circumvent the organization's highest authority when [the highest authority] persists in a course of action that is clearly violative of law or a legal obligation to the organization and is likely to result in substantial injury to the organization. These situations are governed by Rule 1.05... If the lawyer does not violate a provision of Rule 1.02 or Rule 1.05 by doing so, the lawyer's further remedial action, after exhausting remedies within the organization, may include revealing information relating to the representation to persons outside the organization.

However, the mandates of Rule 1.12 are not the only provisions of the Texas Disciplinary Rules of Professional Conduct that could impose an obligation to disclose confidential information to the creditors of an insolvent corporation. Texas Rule 1.05(f) requires that a lawyer reveal confidential information "when required to do so by Rule 3.03(a)(2), 3.03(b), or by Rule 4.01(b)."[8]

Under Rule 4.01, an attorney is required to disclose information to third parties (*e.g.*, creditors) to the extent necessary to avoid making the lawyer a party to a criminal act or knowingly assisting a fraudulent act perpetrated by a client. For whatever reason, the committee assumed that Rule 1.05(f) was inapplicable and left unaddressed possible Rule 4.01 disclosure requirements.

Rules 1.05(f) and 4.01 are of practical importance when determining whether disclosure to creditors should or must be made[9] because most debtors' attorneys routinely have substantial communications with creditors,[10] and creditor lawsuits against a debtor's attorney are typically based on theories such as negligent misrepresentation,[11] aiding and abetting breaches of fiduciary duty by the client[12] and conspiracy with the client.[13]

Relevant Texas Rules of Professional Conduct Compared with ABA Model Rules

The ABA Model Rules of Professional Conduct,[14] in some respects, favor even more the protection of confidentiality than do the Texas Rules. The ABA Model Rule of Professional Conduct comparable to Texas Rule of Professional Conduct 1.05 is 1.6. Unlike its Texas counterpart, ABA Model Rule 1.6 does not include any mandatory disclosure requirements. This dramatic distinction is well illustrated by the difference between the two rules dealing with the prevention of death or serious bodily harm. Texas Rule 1.05(e) requires disclosure if reasonably necessary to prevent a criminal or fraudulent act that is likely to result in death or serious bodily harm. ABA Model Rule 1.6(b)(1), on the other hand, permits—but does not require—a lawyer to disclose confidential information if reasonably necessary to prevent reasonably certain death or bodily harm.

With respect to the fact situation described in Opinion 603 and the issue of permissive disclosure, the ABA Model Rule again favors more protection of confidentiality. Whereas the Texas Rule requires the attorney to consider, among other factors, the probability and magnitude of the financial or property injury, ABA Model Rule 1.6(b)(2) permits disclosure only if the probability of injury is "reasonably certain" and the magnitude of the potential injury is "substantial."

As discussed, an attorney proceeding under Texas Rule 1.12 dealing with representation of an organization "must take

7 *Id.* (emphasis added).

8 Rules 3.03(a)(2) and 3.03(b) address a lawyer's obligations of candor toward courts. Rule 4.01 addresses the lawyer's obligations of truthfulness in statements to others (such as creditors).

9 Texas Disciplinary Rules of Professional Conduct do not establish a standard of care, and violations of them do not typically create a basis for civil liability by clients or third parties, and potential civil liability is not an issue with the committee. *See, e.g.*, Texas Disciplinary Rules of Professional Conduct, Preamble paragraph 15. The converse is not true. Misconduct by the attorney triggering civil liability exposure to clients and third parties can also result in violations of ethical duties. *See, e.g., Petrillo v. Bachenberg*, 655 A.2d 1354, 1357 (N.J. 1995).

10 Distribution of disclosure statements and reorganizational plans are examples. Even the disclosures to creditors contemplated by Opinion 603 would be communications with third parties subject to the ethical mandates of Rule 4.01.

11 *McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests*, 991 S.W.2d 787 (Tex. 1999).

12 *Millbank v. Holmes (In re TOCFHBF Inc.)*, 413 B.R. 523 (Bankr. N.D. Tex. 2009).

13 *Id.*

14 Most states have adopted some form of the ABA Model Rules. None have adopted them verbatim.

remedial action" under the described circumstances to prevent "substantial harm" to the organization as a "likely" result of the misconduct by one of the organization's agents. ABA Model Rule 1.13(b) states that under such circumstances, the lawyer "shall proceed as is reasonably necessary in the best interest of the organization." ABA Model Rule 1.13(c) clearly contemplates disclosure outside the organization and, in contrast to the Texas Rule, adds that such disclosure can be made even if otherwise prohibited by ABA Model Rule 1.6.

With respect to situations implicating ethical rules dealing with representations to third parties, there is one significant distinction between the ABA Model Rule 4.1 and Texas Rule 4.01: Both require disclosure if necessary to avoid knowingly assisting a criminal or fraudulent act perpetrated by a client. However, ABA Model Rule 4.1(b) contains the restriction "unless disclosure is prohibited by Rule 1.6." It is difficult to imagine under what circumstances ABA Model Rule 1.6 would prohibit sufficient disclosure to protect the attorney from knowingly assisting a criminal or fraudulent act perpetrated by a client.

In the *Rohrback* case, the appellate court resolved that "legal ethics nightmare" against the attorney. It concluded that mere silence by an attorney who, in reliance on his duty to preserve client confidences, knowingly failed to correct his client's identity deception to an investigating officer at a presentence investigation constituted a violation of ABA Model Rule 4.1 (misrepresentation to third parties), justifying a 45-day suspension.[15]

Conclusion

Where management of an insolvent debtor has breached—or is breaching—its fiduciary duties, the attorney representing that debtor faces an increased level of personal risk. Failure by the attorney to recognize that risk and implement appropriate action can result in severe consequences, including formal grievances, court sanctions and direct or derivative civil lawsuits against the attorney for, *inter alia*, breach of fiduciary duty, legal malpractice, aiding and abetting breaches of fiduciary duty and conspiracy. Possible "appropriate action" generally cannot be limited to consideration of the permissive disclosures such as those described in Texas Rule 1.05(c)(7), but should include consideration of the various mandatory disclosure requirements.[16]

Avoiding or minimizing exposure to such undesirable consequences begins with diligent and documented efforts to stop or correct management's breaches of fiduciary duties. Once such internal efforts have been exhausted and proven futile, the attorney must consider more drastic options, including resignation or making disclosure to a creditor or the creditor body. The extent of any disclosure will be fact-specific, but should be as limited as reasonably necessary to prevent the crime, fraud or resulting injury. Caution is required to ensure that such disclosures in themselves are not misleading. ■

15 *Rohrback, supra*, at 591 A.2d 497-99.

16 If disclosure to creditors or other third parties may be necessary, Comment 6 to Texas Rule 1.12 suggests that "[a]t some point it may be useful or essential to obtain an independent legal opinion."

Financial Statements: Peace of Mind for Banks and Regulators

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Amendment[4] puts the onus on regulators to make sure that insured depository institutions and depository holding companies retain enough capital to absorb losses during periods of market dislocation. To that end, the Dodd-Frank Act mandates annual stress tests under various types of economic conditions for banks with more than $50 billion in assets.

Greater Relevance, Wider Application

The Dodd-Frank Act was aimed squarely at larger financial institutions with systemic-risk potential. However, the implications of risk for smaller and midsize regional banks are equally applicable. While larger banks were shoring up their tier 1 capital levels—the primary gauge of a bank's strength relative to its assets—community banks took the recession on the chin in 2009. Most banks were well-capitalized before the housing market crisis and economic downturn, but the substantial increase in nonperforming loans and defaults sapped loan loss reserves and portfolio performance. Credit for businesses dwindled, and capital for banks dried up. In the aftermath, the number of bank failures soared to 140, according to FDIC statistics.

In 2010, 157 banks failed, a 12 percent increase from 2009. To put those failure rates into perspective, the total for the past two years exceeds the cumulative total for the previous eight years. Despite stabilization in the nation's equity and debt-capital markets and improving economic conditions, the capacity to sustain large loan losses and continue lending in a difficult economic environment remains a questionable prospect for many community and smaller banks. This article uses these terms interchangeably.

Regulators have not yet required banks with less than $10 billion in assets to perform stress tests, but the financial fallout from nonperforming loans is an all-too-real risk for banks of all sizes. Large numbers of distressed residential properties and foreclosures, coupled with declining home prices, continue to cast a long shadow over the housing market. At the same time, sluggish economic growth, troubled commercial real estate assets and an unemployment rate that the Department of Labor calculated at 9.4 percent in December 2010 are all clouding the horizon for the banking industry.

Federal Reserve Chairman Ben Bernanke underscored the importance of stress testing for all banks on May 6, 2010, when he said that bankers (and other financial services firms) need to conduct their own stress tests. He explained that the tests "force bankers to think through the implications of scenarios that may seem relatively unlikely but could pose serious risks.... Stress tests must be an integral part of [firms'] processes for ensuring their capital is adequate."[5] These developments highlight the need for management and boards of directors to conduct thorough analyses of their banks' loan and investment portfolios and operations, including the impact on net interest margin, fee income and other sources of revenue and loss impairment, as well as an ongoing review of internal processes and controls, in order to assess and manage risk appropriately.

4 The provisions of the Collins Amendment are contained in § 171 of the Dodd-Frank Act. Section 171 directs the appropriate federal banking agencies to establish minimum leverage and risk-based capital requirements, on a consolidated basis, for insured depository institutions, depository institution holding companies and nonbank financial companies that are supervised by the Federal Reserve. The Collins Amendment will create statutory floors for minimum leverage and risk-based capital and U.S. banking regulators would be able to implement Basel III only to the extent it is consistent with the Collins Amendment floor.

5 Chairman Ben Bernanke at the Federal Reserve Bank of Chicago presenting at the 46th Annual Conference on Bank Structure and Competition on May 6, 2010.

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AN ATTORNEY'S ETHICAL DUTY TO DISCLOSE CONFIDENTIAL INFORMATION TO CREDITORS OF AN INSOLVENT CLIENT

E. P. Keiffer
Wright Ginsburg Brusilow PC
325 N. St. Paul St., Suite 4150
Dallas, Texas 75201

Editing, guidance and comments provided by:

Holland N. O'Neil
Gardere Wynne Sewell LLP
1601 Elm Street, Suite 3000
Dallas, Texas 75201

Leslie Luttrell
Luttrell + Villarreal Law Group
400 N. Loop 1604E, Suite 208
San Antonio, Texas 78232

Honorable Ronald B. King
Chief Bankruptcy Judge
Western District of Texas
Hipolito F. Garcia Federal Building and U. S. Courthouse
615 E. Houston St., Room 383
San Antonio, Texas 78205

In November 2010, the Professional Ethics Committee for the State Bar of Texas (the "TX Ethics Committee") issued Opinion No. 603[1], which opined on the following question[2]:

> *Do the Texas Disciplinary Rule of Professional Conduct require or permit a lawyer to reveal to a corporation's creditors the lawyer's advice to the corporation that the person who owns and manages the corporation has engaged in conduct that constitutes a breach of the person's fiduciary duty to the corporation?*

The basic facts giving rise to Opinion No. 603 were posited as follows:

1. ***Lawyer represents insolvent corporation.***

2. ***Corporate Representative is the sole shareholder, sole officer and sole director of insolvent corporation.***

3. ***Lawyer concludes that Corporate Representative is breaching his fiduciary duties to the corporation and will likely cause substantial harm to its creditors.***

4. ***The Corporate Representative actions are not criminal.***

5. ***Lawyer advises Corporate Rep to stop, but the Corporate Rep continues breaching fiduciary duties.***

6. ***Corporate Rep tells Lawyer not to share his conclusions with the creditors.***

The TX Ethics Committee concluded that:

> *A lawyer may reveal, but is not required to reveal, to a corporation's creditors the lawyer's advice to the corporation that conduct of the person who owns and manages the corporation constitutes a breach*

1 The full text of Opinion 603 and its comments are attached.

2 While this panel discussion and this paper will utilize Texas Disciplinary Rules of Professional Conduct as its baseline authority, each state's version needs to be consulted to determine what variations their state may have as to these rules, if any. That being said, it is unlikely that the material differences as to what counsel must do when in a similar situation outside of a Title 11 proceeding as opposed to being counsel in an applicable Title 11 proceeding will change as the underlying state law changes.

of fiduciary duty owed to the corporation only if: (1) the breach of fiduciary duty results in fraud by the corporation, (2) the lawyer has attempted to, but has been unable to, dissuade the corporation from committing the fraud, and (3) the lawyer has reason to believe that revealing the confidential information is necessary to prevent the fraud. Any such disclosure must be limited in manner and content to the minimum that the lawyer believes is necessary to prevent the fraud.

The TX Ethics Committee analyzed Rules 1.02(d), 1.05(b), 1.05(c)(7), 1.12 and 1.15(b)(4) of the Texas Disciplinary Rules of Professional Conduct:

Rule 1.05(b) provides:

(b) Except as permitted by paragraphs (c) and (d), or as required by paragraphs (e), and (f), lawyer shall not knowingly:

1) Reveal confidential information of a client or a former client to:

(i) a person that the client has instructed is not to receive the information; or

(ii) anyone else, other than the client, the client's representatives, or the members, associates, or employees of the lawyer's law firm.

2) Use confidential information of a client to the disadvantage of the client unless the client consents after consultations.

3) Use confidential information of a former client to the disadvantage of the former client after the representation is concluded unless the former client consents after consultation or the confidential information has become generally known.

4) Use privileged information of a client for the advantage of the lawyer or of a third person, unless the client consents after consultation.

Rule 1.05(c)(7) sets forth the exception to this general prohibition, and provides:

(c) A lawyer may reveal confidential information:

(7) When the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or fraudulent act.

Comment 1 to Rule 1.05 states:

Both the fiduciary relationship existing between lawyer and client and the proper functioning of the legal system require the preservation by the lawyer of confidential information of one who has employed or sought to employ the lawyer. Free discussion should prevail between lawyer and client in order for the lawyer to be fully informed and for the client to obtain the full benefit of the legal system. The ethical obligation of the lawyer to protect the confidential information of the client not only facilitates the proper representation of the client but also encourages potential clients to seek early legal assistance.

Rule 1.02(d) provides:

(d) When a lawyer has confidential information clearly establishing that a client is likely to commit a criminal or fraudulent act that is likely to result in substantial injury to the financial interests or property of another, the lawyer shall promptly make reasonable efforts under the circumstances to dissuade the client from committing the crime or fraud.

Rule 1.12 provides:

Rule 1.12 Organization as a Client

(a) A lawyer employed or retained by an organization represents the entity. While the lawyer in the ordinary course of working relationships may report to, and accept direction from, an entity's duly authorized constituents, in the situations described in paragraph (b) the lawyer shall proceed as reasonably necessary in the best interest of the organization without involving unreasonable risks of disrupting the organization and revealing information relating to the representation to persons outside the organization.

(b) A lawyer representing an organization must take reasonable remedial actions whenever the lawyers learns or knows that:

(1) an officer, employee, or other person associated with the organization has committed or intends to commit a violation of a legal obligation to the organization or a violation of law

which reasonably might be imputed to the organization;

(2) the violation is likely to result in substantial injury to the organization; and

(3) the violation is related to a matter within the scope of the lawyer's representation of the organization.

(c) Except where prior disclosure to persons outside the organization is required by law or other Rules, a lawyer shall first attempt to resolve a violation by taking measures within the organization. In determining the internal procedures, actions or measures that are reasonably necessary in order to comply with paragraphs (a) and (b), a lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyers representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters, and any other relevant considerations. Such procedures, actions and measures may include, but are not limited to, the following:

(1) asking reconsideration of the matter;

(2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and

(3) referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization as determined by applicable law.

(d) Upon a lawyer's resignation or termination of the relationship in compliance with Rule 1.15, a lawyer is excused from further proceeding as required by paragraphs (a), (b) and (c), and any further obligations of the lawyer are determined by Rule 1.05 (e). In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when it is apparent that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing or when explanation appears reasonably necessary to avoid misunderstanding on their part.

The TX Ethics Committee recognized the distinction between whether the Corporate Representative's conduct constituted a crime or fraud. Since the Lawyer concluded that no crime had been committed, the TX Ethics Committee considered that not all breaches of fiduciary duty are

fraudulent (citing *Duncan v. Lichtenberger*, 671 S.W. 2d 948, 954 (Tex-App. – Fort Worth 1984, *writ ref'd, n.r.e.*) (fraud is not a required element of breach of fiduciary duty)). Nothing in the Texas Disciplinary Rules would authorize the lawyer to reveal his conclusions to the creditors where no fraud or criminal activity was about to occur.

Further, because the client is a corporation, Rule 1.12 applies. Rule 1.12(b) requires a lawyer to act when an officer's or employee's breach of an obligation to the corporation will likely result in substantial harm to the organization. But here, under the facts, because the corporation was already insolvent, the TX Ethics Committee concluded that there would be no harm to "the organization" (only harm is to the creditors).

While one could clearly differ with this analytical conclusion of no harm to the organization on the basis that creditors of an insolvent company are generally seen as the holders of beneficial interest in the corporation's assets, supplanting the interests of the shareholders who heretofore elected the directors who appoint and police the officers whose conduct is at issue; there is a paucity of cases on when or if that functional status ever ripens into something more than an intellectual discussion. In the context of the TX Ethics Committee's discussion and requirement of fraud (actual not constructive) or an actual crime about to be committed, especially in light of the meteoric rise and equally fast demise of the theory of deepening insolvency as being a cause of action through which officers and directors may be held accountable (*see, e.g., In re VarTec Telecom, Inc.*, 335 B.R. 631 (Bankr. N.D. Tex. 2005)), the Committee's conclusion should, nevertheless, be heeded.

The Committee concluded that because no crime or fraud was taking place, the facts did not fall within paragraphs (e) and (f) of Rule 1.05[3] that require the lawyer to reveal confidential information. Finally, as an apparent last resort, the Committee offered that the Lawyer could withdraw

3 (e) When a lawyer has confidential information clearly establishing that a client is likely to commit a criminal or fraudulent act that is likely to result in death or substantial bodily harm to a person, the lawyer shall reveal confidential information to the extent revelation reasonably appears necessary to prevent the client from committing the criminal or fraudulent act.

(f) A lawyer shall reveal confidential information when required to do so by Rule 3.03(a)(2), 3.03(b), or by Rule 4.01(b).

under Rule 1.15(b)(4)[4].

Rule 1.15(b)(4) provides:

> *(b) Except as required by paragraph (a), a lawyer shall not withdraw from representing a client unless:*
>
> > *(4) a client insists upon pursuing an objective that the lawyer considers repugnant or imprudent or with which the lawyer has fundamental disagreement;*

For a fine discussion of these issues in a non-bankruptcy context and for more detail on how the Committee came to its conclusion please refer to our Co-Chair, Frank Broyles' article in the ABI Journal, Vol. XXX, No. 4 (April, 2011) beginning at page 22 (a copy of which is attached).

The ABA Model Rules of Professional Conduct provide for even more protection of confidentiality than do the Texas Rules and as noted hereafter, the ABA Model Rules may be a reference point for Federal Courts to look to regarding these issues. ABA Model Rule 1.6 states:

> *(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;*

4 Although rife with much more egregious facts and circumstances than those set forth in Opinion 603, the attached Motion to Withdraw as Counsel in *LBDS Holding Company, LLC v. ISOL Technology, Inc. et al* Case No. 6:11-cv-00428-LED is a stunning example of what can happen and what needs to be done when counsel represents those who committed fraudulent and likely criminal actions (all the while hidden from counsel) before a tribunal.

(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.

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Notably, ABA Rule 1.6 does **not** include any mandatory disclosure requirements. It addresses permissive disclosure if reasonably necessary to prevent reasonably certain death or bodily harm. In the fact scenario confronted by the TX Ethics Committee, the ABA Rule would protect the confidentiality.

Disputes in Federal Court

In the various types of federal courts, the Federal Rules of Evidence provide that the attorney-client privilege is determined by reference to federal law when federal law supplies the substantive rule of decision (generally when federal question jurisdiction applies) and by state law when the state law supplies the substantive rule (generally when diversity jurisdiction applies) . See Fed.R. Evid. 501. So unless there is a specified body of federal law that addresses attorney-client

relationships in the context of appearing in a federal question matter before a federal court, the state rules, (with likely reference to the ABA's Rules through local rule incorporation of same) that are discussed above should apply and thus guide counsel's actions.

Filing for Relief under Title 11 and the Change it Causes.

The intervention of bankruptcy of the client has significant impact on what can be the subject of an attorney-client privilege, principally because of the myriad of statutes and rules which define the Debtor's duties in the type of case filed. What heretofore could be cloaked under the veil of attorney-client privilege and could not be revealed unless the very stringent requirements referenced in Opinion 603 applied, in many instances would generate significant risk to Debtor's counsel and the appointment of a trustee in a Chapter 11 context.

In all filing chapters, the requirements of § 521 "Debtor's duties" (and the implementing Rules 1007-1009) is a starting point in explaining why Opinion 603 may have limited application in the context of a filing for relief under Title 11. Financial information requirements we are all very familiar with require significant disclosure which would be untenable outside of a bankruptcy proceeding. Since Opinion 603 references an ongoing enterprise, the remainder of this analysis will put the company and its now counsel for the DIP into a Chapter 11 context, as it seems to be where more comparisons and contrasts can be drawn.[5]

The operating overlay of Section 363's requirement of operating in the ordinary course of business[6] ("OCB") and Section 549's ability to claw back transfers made that do not meet 363's

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5 Chapter 7s of entities (not individuals) occasion a transition as to who controls the attorney-client privilege for the entity and thus the ability of pre-petition counsel to inform the replacement fiduciary (the Chapter 7 Trustee) should enable concerned counsel to detail the troublesome information to the Chapter 7 Trustee, subject, of course to the gnarly problem of not having made it clear to the sole owner, director, officer who you were representing – a bridge too far for this debate.

6 This constraint has some plasticity, but cases explaining the vertical (creditor perspective on economic risk that is of a different nature from that existed when credit was extended) and horizontal (industry wide perspective on whether action is commonly undertaken by companies in that industry) tests give guidance on its limits. See *Brownstein v. McCabe* 571 F3d 108, 124-26 (1st Cir. 2009)

OCB requirement and thus would not have authorization to be made, will have an impact on disclosure of what might otherwise be seen as privileged information in a non-bankruptcy context. Bear in mind, until the decision is made to pursue a non OCB transaction, applicable data and discussions regarding same should be considered subject to attorney-client privilege. Close decisions on what is or is not OCB and what disclosure is required if seeking approval under 363, are examples that may pose dilemmas similar to the one described in Opinion 603.

But even in such an instance, there are additional Code requirements that must be borne in mind. General counsel for the DIP is not strictly counsel to the entity, but rather to the estate that is created under Section 541 of the Code that is administered by the officers and directors (or other equivalent types for other entity permutations). Moreover, unlike the counsel in Opinion 603, debtor's counsel's employment, the ability to be paid and the prospect of discipline for misbehavior that resides with the client alone, now, by and through having to meet Sections' 327-330's conditions to be employed as counsel and to be compensated for work performed, can functionally, and in the proper context, be brought before the Bankruptcy Court by: a) any creditor in the case; b) any fiduciary in the case; c) equity interest holders (if likely "in the money"); d) the United States Trustee's Office; and e) the Court itself. What had been something one must hold one's tongue regarding unless actual fraud or a crime is about to be committed, is now quite a different kettle of fish. This is principally because counsel for the DIP is counsel for the estate created when the issues get dicey. The predisposed position outside of Chapter 11 is erring on the side of non-disclosure. The converse is more likely to hold DIP's counsel in good stead inside Chapter 11.

No Claim of Privilege to Communications related to Required Disclosures

This obligation of disclosure is recognized as functionally otherwise controlling federal law. In *U.S. v. White*, 950 F. 2d 426 (7th Cir. 1991) the Seventh Circuit held that the privilege was not applicable to drafts of bankruptcy papers and interview notes of the debtor's attorney in the absence of specification as to what information the client expected to be kept confidential.

When information is disclosed for the purpose of assembly into a

> *bankruptcy petition and supporting schedules, there is no intent for the information to be held in confidence because the information is to be disclosed on documents publicly filed with the bankruptcy court ...*

The court in *In re Eddy*, 304 B.R. 591 (Bankr. D. Mass. 2004) similarly concluded that communications of information required to be disclosed are not privileged:

> *A debtor has no reasonable expectation that information will be kept confidential if it must be disclosed in bankruptcy filings, and where the Debtor has no reasonable expectation of confidentiality, the attorney-client privilege is unavailable.*

When combined, these holdings posit that what must be disclosed in bankruptcy filings is not subject to confidentiality. This position is not limited, necessarily to schedules and statements of affairs, but is pervasive with regard to what a DIP must file to seek the Court's approval. There are limits, however, even in Chapter 11, to what is necessary to disclose. Commercially sensitive data which is of the nature of a trade secret as to product/services and/or operational processes, formulas and methodologies as to the Debtor's operations that would not be disclosed outside of Chapter 11 and which are not otherwise specifically required to be disclosed to meet a specific Bankruptcy Code or Rule requirement, other than in general parlance (secret formula for making X listed in the schedules or sufficient information in a disclosure statement to meet the requirements of Section 1125) clearly remains confidential.

Addressing the Problem – DIP Counsel's Principal Option

But Opinion 603 does not address the kinds of circumstances referenced above. It addresses actions being taken by a fiduciary that DIP counsel knows will clearly harm the rights of the actual beneficiaries of the insolvent entity by breaching a fiduciary duty owed

to that entity, but which actions are not on their own fraudulent or criminal. In a Chapter 11 proceeding counsel for the DIP, on account of the noted differences in who one's client is and who all can complain about same, will have to react well before this threshold is approached. This is where the means to address the problem are both similar and yet quite different.

Opinion 603 provides that counsel could withdraw from representing the client under Texas' Rule 1.15(b)(4). But this is a silent withdrawal, there can only be noted that a difference that the rules allows as a basis for the withdrawal under the circumstances described. If there is no litigation involved, then no one else will ever have any reason to suspect anything untoward was afoot relative to the entities creditors, just because counsel withdrew representation. But counsel for a DIP of course has to secure authority to withdraw. It is virtually assured that there will be a hearing on motion, even if substitute counsel is secured by the DIP. If there is no succeeding counsel proposed by the DIP, leaving the DIP without counsel will generally cause the Court to inquire- why? So in the latter instance of no succeeding counsel, if the withdrawal is not sufficiently "noisy" and does not give the Court some indication that something "is rotten in Denmark" then the otherwise operative impediment of not withdrawing as counsel when doing so would have a material adverse effect upon the interests of the client, may stand in your way.

Moreover, as counsel to the DIP, your client is the estate and the one currently housed with the authority to act for the DIP, must act appropriately. The DIP generally takes the full weight of the mantle of a trustee and like all instances where there is an estate and a

trust (here statutory) and beneficiaries[7] what might otherwise be confidential, may not be so cloaked. In this instance all of the bankruptcy estate's likely beneficiaries (i.e. the creditors in the Opinion 603 example) should be able to inquire as to whether the circumstances that caused this withdrawal are privileged or not and whether sufficient information should be divulged in some manner to justify the sought withdrawal. It is likely a better tack to be more forthcoming as to your concerns, indicating that as a putative administrative creditor, you have significant concerns about the fealty of the DIP's representatives to their requirements to act so as to not breach fiduciary duties they have to the estate and thus cause harm to the estate by their continuing a harmful course of conduct that is less than fraudulent or criminal.

Cleary this is a very difficult place to be and it should be one that counsel for DIPs should rarely have to navigate. But it can and it does happen. As an entity's counsel, do not confuse disclosure prohibition requirements outside of a Chapter 11 context with what has to be done in a Chapter 11 context; you will not fare well when you seek allowance of your fees and expenses.

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7 Because Opinion 603 has only one actor for all roles in the entity, in a non-bankruptcy situation, the correlative example of having to inform other shareholders that likely would arise in such an instance outside of bankruptcy, is not present. See *Ethical Issues in Bankruptcy Litigation* by Judge Paul Bonapfel (U.S. Bankruptcy Judge N.D. Ga.) that appeared in the ABI's Atlanta Consumer Bankruptcy Skills Training 2010 at pages 95-156, particularly pages 132-134 (available at: http://materials.abi.org/conference-name/atlanta-consumer-bankruptcy-skills-training for ABI members) where the Restatement (Third) of Law Governing Lawyers Sections 84 and 85 are discussed as to express trusts and corporate entities.

ETHICS OPINIONS

ISSUED BY THE PROFESSIONAL ETHICS COMMITTEE FOR THE STATE BAR OF TEXAS

Opinion No. 603, November 2010

QUESTION PRESENTED

Do the Texas Disciplinary Rules of Professional Conduct require or permit a lawyer to reveal to a corporation's creditors the lawyer's advice to the corporation that the person who owns and manages the corporation has engaged in conduct that constitutes a breach of the person's fiduciary duty to the corporation?

Statement of Facts

A lawyer represents an insolvent corporation that is controlled and managed by an individual who is the corporation's sole shareholder, sole director, and sole officer (the "Corporate Representative"). The lawyer concludes that the Corporate Representative is engaged in conduct that, although not criminal, constitutes a breach of the Corporate Representative's fiduciary duty to the corporation and that the conduct will likely result in substantial harm to the corporation's creditors. Because of the corporation's insolvency, the Corporate Representative's breach of fiduciary duty is unlikely to cause any material harm to the corporation but is likely to cause significant harm to the corporation's creditors. The lawyer advises the Corporate Representative that his conduct constitutes a breach of his fiduciary duty to the corporation and should be stopped. The Corporate Representative nevertheless continues his conduct and specifically instructs the lawyer not to share the lawyer's conclusions or advice with the corporation's creditors.

Discussion

Preservation of a client's confidential information is one of the fundamental obligations of a lawyer. "Both the fiduciary relationship existing between lawyer and client and the proper functioning of the legal system require the preservation by the lawyer of confidential information of one who has employed or sought to employ the lawyer." Comment 1 to Rule 1.05 of the Texas Disciplinary Rules of Professional Conduct. Conclusions reached by a lawyer regarding the conduct of a corporate client's representative and the resulting advice that the lawyer gives to the corporation are "confidential information" as defined in Rule 1.05(a).

Rule 1.05(b) provides that, with certain exceptions, a lawyer shall not knowingly "(1) Reveal confidential information of a client or a former client to: (i) a person that the client has instructed is not to receive the information . … " An exception to this general prohibition that requires particular consideration with respect to the factual situation presented here is specified in Rule 1.05(c)(7), which provides that a lawyer may reveal a client's confidential information "[w]hen the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or fraudulent act." The Terminology section of the Rules provides that "'Fraud' or 'Fraudulent' denotes conduct having a purpose to deceive and not merely negligent misrepresentation or failure to apprise another of relevant information."

An initial question in the circumstances considered here is whether the Corporate Representative's breach of fiduciary duty to the corporation results in conduct by the corporation that constitutes a crime or fraud. In this case, the lawyer has concluded that the corporation's conduct resulting from the breach of fiduciary duty does not constitute a crime. As to fraud, not all breaches of fiduciary duty are fraudulent. See *Duncan v. Lichtenberger*, 671 S.W.2d 948, 954 (Tex. App. — Fort Worth 1984, writ ref'd, n.r.e.) (fraud is not a required element of breach of fiduciary duty). If the Corporate Representative's breach of fiduciary duty does not result in corporate conduct constituting fraud, then nothing in the Texas Disciplinary Rules would authorize the lawyer to reveal the lawyer's conclusions and advice to the corporation's creditors.

On the other hand, if the Corporate Representative's breach of fiduciary duty results in fraud likely to result in substantial financial harm, Rule 1.02(d) requires that the lawyer attempt to dissuade the corporate client from engaging in such conduct:

> When a lawyer has confidential information clearly establishing that a client is likely to commit a criminal or fraudulent act that is likely to result in substantial injury to the financial interests or property of another, the lawyer shall promptly make reasonable efforts under the circumstances to dissuade the client from committing the crime or fraud.

Because the client is a corporation and the Corporate Representative is violating legal duties to the corporation, the requirements of Rule 1.12, applicable when an organization is a lawyer's client, must be considered. Rule 1.12(b), which requires a lawyer to act when an officer's or employee's breach of an obligation to an organization will likely result in substantial injury to the organization, will not apply because, under the facts presented here, there is no likelihood of significant harm to the corporation. Nevertheless Rule 1.12(c) will apply, requiring that "[e]xcept where prior disclosure to persons outside the organization is required by law or other Rules, a lawyer shall first attempt to resolve a violation by taking measures within the organization." Here, the lawyer has acted within the corporation by raising the issue with the Corporate Representative but the lawyer has not been

successful in causing the client to stop the conduct.

Where, as here, the client insists on continuing in a course of conduct that the lawyer has advised against, the lawyer remains bound by requirements of the Texas Disciplinary Rules to protect the client's confidential information unless an exception applies: "When a client's course of action has already begun and is continuing, the lawyer's responsibility is especially delicate. The lawyer may not reveal the client's wrongdoing, except as permitted or required by Rule 1.05." Comment 8 to Rule 1.02.

The facts here do not fall within the provisions of paragraphs (e) and (f) of Rule 1.05 that *require* the lawyer to reveal confidential information in certain circumstances. As noted above, however, Rule 1.05(c)(7) provides that a lawyer *may* reveal confidential information when the lawyer reasonably believes that disclosing the information is necessary in order to prevent the client from committing a criminal or fraudulent act. In the situation considered, if the Corporate Representative's breach of fiduciary duty results in fraudulent conduct by the corporation, then under Rule 1.05(c)(7), the lawyer is permitted to reveal his conclusions and advice to the extent necessary to prevent the fraudulent conduct, including, if such is necessary, by revealing confidential information to the corporation's creditors. But if the lawyer believes that revealing confidential information to the corporation's creditors would not prevent the fraud, then Rule 1.05(c)(7) would not permit the lawyer to reveal confidential information to the creditors even if the corporation's conduct constituted fraud.

Rule 1.05(c)(7) does not specify to whom confidential information may be revealed when the Rule permits disclosure. Comment 14 to Rule 1.05 explains that "a disclosure adverse to the client's interest should be no greater than the lawyer believes necessary to the purpose." Thus, in the circumstances considered, if fraud is involved and the lawyer chooses to disclose confidential information, the lawyer must do so in a manner that minimizes the extent of the disclosure and the adverse effect of the disclosure upon the corporate client while also accomplishing the goal of preventing the client from committing fraud. For example, if an opportunity exists for confidential disclosure to a court, in camera, and such disclosure would likely be sufficient to prevent the corporation's fraud, then disclosure to the court may be the appropriate course of action.

Finally, regardless of the lawyer's determination with respect to disclosure of confidential information to the client corporation's creditors, the lawyer may terminate his representation of the corporation. Under Rule 1.15(b)(4), one of the circumstances in which a lawyer is permitted to withdraw from representing a client exists when "a client insists upon pursuing an objective that the lawyer considers repugnant or imprudent or with which the lawyer has fundamental disagreement[.]" Such a permitted withdrawal "is optional with the lawyer even though the withdrawal may have a material adverse effect upon the interests of the client." Comment 8 to Rule 1.15. Of course, if the matter is in litigation, a lawyer may not withdraw from representation if the court orders otherwise. See Rule 1.15(c) ("When ordered to do so by a tribunal, a lawyer shall continue representation notwithstanding good cause for terminating the representation."). Rule 1.15(d) requires that, if a lawyer chooses to withdraw from representation, the lawyer must take reasonable steps to protect the client's interests.

Conclusion

A lawyer may reveal, but is not required to reveal, to a corporation's creditors the lawyer's advice to the corporation that conduct of the person who owns and manages the corporation constitutes a breach of fiduciary duty owed to the corporation only if: (1) the breach of fiduciary duty results in fraud by the corporation, (2) the lawyer has attempted to, but has been unable to, dissuade the corporation from committing the fraud, and (3) the lawyer has reason to believe that revealing the confidential information is necessary to prevent the fraud. Any such disclosure must be limited in manner and content to the minimum that the lawyer believes is necessary to prevent the fraud. ✪

The Supreme Court of Texas appoints the nine members of the Professional Ethics Committee for the State Bar of Texas from members of the bar and the judiciary. The Court also appoints the committee's chair. According to Section 81.092(c) of the Texas Government Code, "Committee opinions are not binding on the supreme court."