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BANKRUPTCY ETHICS, AN OXYMORON

[*FN:* It has been said that the most important thing to remember when participating in a chapter 11 is the sequence in which you double−cross your allies. This article was previously published as Professional Responsibility and the Bankruptcy Lawyer , 32−Jun Bull. Bus. L. Sec. St. B. Tex. 1 (1995) and has been updated and revised for publication in this law review.]

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Introduction

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As representatives of clients as well as officers of the court, [*FN:* See Baker v. Humphrey, 101 U.S. 494, 502 (1879) (referring to attorneys as officers of law, as well as agents of those by whom they are employed);*In re* Arlan's Dep't Stores Inc., 615 F.2d 925, 932 (2d Cir. 1979) (stating counsel for debtor is officer of court and bound by fiduciary standards) (citing Brown v. Gerdes, 321 U.S. 178, 182 (1944)); Finn v. Childs Co., 181 F.2d 431, 441 (2d Cir. 1950) (stating persons who seek compensation for services or reimbursement for expenses are held to fiduciary standards).] attorneys frequently are required to consider the implications and propriety of proposed courses of action on behalf of their clients. [*FN:* Clients seem to think that hiding assets is the principal reason to retain bankruptcy counsel.] Although each situation may present distinct problems of its own, attorneys must deal with at least three sources of ethical considerations: [*FN:* Strangling clients is also unethical, but its propriety is beyond the scope of this Article.] (1) the minimal standards governing conduct expressed by the ABA and the respective state bodies which, if violated, may subject the lawyer to formal disciplinary action, [*FN:* Each state has enacted its own set of professional conduct rules which are typically taken from the ABA Model Code of Professional Responsibility (the "Model Code"), the ABA Model Rules of Professional Conduct (the "Model Rules") or from a combination of both sources.] (2) the aspirational goals, which are normally not mandatory rules, but are urged and recommended by the ABA and several states, [*FN:* See*In re* Palumbo Family Ltd. Partnership, 182 B.R. 447, 467 (Bankr. E.D. Va. 1995) (explaining that unlike disciplinary rules, ethical considerations are aspirational in character and fail to supply basis for sanctions); Pereira v. Houze Glass Co. (*In re* Grakk Mktg. Corp.), 42 B.R. 801, 802 (Bankr. S.D.N.Y. 1984) (stating while ethical considerations accompanying each Canon are merely aspirational, disciplinary rules in each Canon set minimum standard of conduct each lawyer must follow).] and (3) the attorney's own conscience and morality. [*FN:* It has been speculated that following rules does not constitute the practice of ethical behavior. Ethics are needed when there are no rules to guide a person.] For bankruptcy cases in particular, there is yet a fourth set of significant considerations when evaluating a proposed course of action−−the Bankruptcy Code, Bankruptcy Rules and related statutes. [*FN:* See generally 11 U.S.C. § 327 (a) (1994) (requiring professionals retained to be disinterested);*In re* NBI Inc. 129 B.R. 212, 217−18 (Bankr. D. Colo. 1991) (stating Code sections 327 through 331 and Bankruptcy Rule 2016(a) monitor ethical conduct of bankruptcy attorneys);*In re* Vanderbilt Assocs., Ltd., 117 B.R. 678, 680 (D. Utah 1990) (finding attorneys in bankruptcy courts are governed by two separate sources of law−−the Bankruptcy Code and ethical rules governing conduct of attorneys appearing before the court);*In re* Glenn Elec. Sales Corp., 99 B.R. 596, 599 (D.N.J. 1988) (discussing relevance of Bankruptcy Rule 2014(a) for attorney seeking compensation).]

This Article describes selected ethical issues and problems that are commonly confronted by bankruptcy lawyers. Part I discusses possible pitfalls in prebankruptcy asset planning, including cases where the debtor attempted to exonerate himself by claiming that he relied on advice of counsel. It also raises concerns faced in the conversion of nonexempt assets into exempt assets. Part II addresses several, often subtle problems of divided loyalty and points out several specific situations of which bankruptcy attorneys should be aware. Lastly, Part III addresses the various consequences an attorney may face when the court finds an ethical violation. Part IV examines how attorneys should act to avoid problems.

I. Ethical Considerations in PreBankruptcy Asset Planning

("Yacht! What yacht? I don't own a yacht. Haven't owned

a yacht since last month.")

A. Bankruptcy Crimes and Fraudulent Transfers

It has been estimated that at least ten percent (10%) of bankruptcy cases filed in a recent year involved some sort of criminal activity, usually concealment of assets that should have been scheduled. [*FN:* See Safford, "The Slippery Slope," The Road From Ethical Practice to Attorney Negligence, Contempt or Fraud in Bankruptcy Cases, 66th National Conference of Bankruptcy Judges, Oct., 1992 (unpublished material, on file with authors) (discussing Justice Department's significant increase in effort against bankruptcy crimes). Of course, the Justice Department's funding is predicated upon the perceived existence of increasing criminal activity.] While some asset planning is outright criminal, the danger of which attorneys must be cautious lies in the domain between "asset−planning" and "fraud." Even those attorneys who insist that they would never actually commit any fraud, [*FN:* Whatever that is.] should be on guard due to the broad coverage of title 18 sections 152 through 157, which criminalize certain types of transfers intended to defeat provisions of the Bankruptcy Code or give creditors improper advantages. [*FN:* See 18 U.S.C. §§ 152−157 (1994); see also United States v. Ballard, 779 F.2d 287, 293 (5th Cir.), *cert. denied* , 475 U.S. 1109 (1986) (requiring attorney to testify about transfers not disclosed on bankruptcy schedules based on "crime/fraud" exception to attorney−client privilege); United States v. Rogers, 722 F.2d 557, 559 (9th Cir. 1983), *cert. denied* , 469 U.S. 835 (1984) (transferring assets on eve of bankruptcy was violation of 18 U.S.C. § 152).] Attorneys must be aware of these provisions; otherwise, they could be unwittingly implicated in bankruptcy fraud. These sections, some recently added and/or expanded to provide more extensive coverage, [*FN:* In 1994, Congress not only revised and clarified the existing provisions of 18 U.S.C. §§ 152, 153, and 154, it added two new sections, §§ 156 and 157. See 18 U.S.C. §§ 152, 153, and 154, as amended by Pub. L. No. 103−394, § 312, 108 Stat. 4107, 4138−40 (1994); 18 U.S.C. §§ 156, 157, as amended by Pub. L. No. 103−394, § 312, 108 Stat. 4107, 4140 (1994). Section 157 makes it a crime for a person to fraudulently file a chapter 11 petition or document, or make false or fraudulent representation, claim or promise in relation to a chapter 11 proceeding. See 18 U.S.C. § 157. Section 156 was added to cover the knowing disregard of bankruptcy law or rules. 18 U.S.C. § 156.] list several situations that could subject an attorney to significant consequences including fine, imprisonment up to five years, or both. [*FN:* See 18 U.S.C. § 152 (providing fines and/or imprisonment for not more than five years); id. § 153 (same); id. § 157 (same); id. §154 (providing for fine and forfeiture of person's office); id. § 155 (1994) (providing for fines and/or imprisonment for not more than one year); 18 U.S.C. § 156 (same).] Although the sections are not limited to attorneys, [*FN:* See id. §§ 152 −157 (including custodians, trustees, marshals, and other officers of courts, in addition to attorneys). For example, section 152 was primarily aimed at debtors. See Stuhley v. Hyatt, 667 F.2d 807, 809 n.3 (9th Cir. 1982) (noting 18 U.S.C. § 152 primarily aimed at preventing and punishing efforts by debtor to avoid surrendering available property to creditors).] several of the sections specifically mention that attorneys are covered under the statutes. [*FN:* See, *e.g.* , 18 U.S.C. § 152(4) (covering attorneys who knowingly and fraudulently present any false claim for proof against estate of debtor or use any such claim in any case under title 11); § 153 (including attorneys who have access to property or documents belonging to estate); § 155 (regulating fee agreements and specifically including attorneys); see also Coghlan v. United States, 147 F.2d 233, 235−37 (8th Cir.) (interpreting former section 52 of title 18, upon which § 152 is based, finding attorney not immune to punishment for violating statute), *cert. denied* , 325 U.S. 888 (1945).]

Section 152 makes it a criminal offense to "knowingly and fraudulently" conceal assets in relation to chapter 11 cases and proceedings. [*FN:* A somewhat redundant way to define fraudulent activity. See 18 U.S.C. § 152.] If the attorney is unsure whether his client's asset should be reported, the safer route is to report the asset both to the court [*FN:* See United States v. Cherek, 734 F.2d 1248, 1254 (7th Cir. 1984) (finding 18 U.S.C. § 152 properly imposes sanctions on those who preempt court's determination by failing to report assets, even if asset not ultimately determined property of estate under technical bankruptcy rules), *cert. denied* , 471 U.S. 1014 (1985). But see United States v. Collins, 424 F. Supp. 465, 467−68 (E.D. Ky. 1977) (finding in view of uncertainty of law, defendant could not be held to have "knowingly and fraudulently" concealed property, even though it was "property" within meaning of section).] and to the creditors. [*FN:* See United States v. Goodstein, 883 F.2d 1362, 1366−67 (7th Cir. 1989) (transferring ownership and control of corporation in bankruptcy without notice to creditors or bankruptcy court approval could be deemed fraudulent transfer of property and subject to criminal bankruptcy statute), *cert. denied* , 494 U.S. 1007 (1990).] Section 153, which was completely revised in 1994, [*FN:* See supra note 11.] focuses on misappropriation, embezzlement, improper spending and transfers. [*FN:* See 18 U.S.C. § 153.] Section 154 deals with a person who "knowingly purchases, directly or indirectly, any property of the estate in which the person is an officer in a case under title 11." [*FN:* See § 154.] In addition, it punishes officers of the court who knowingly refuse to permit a reasonable opportunity for inspection by authorized persons. [See id.] Section

155 concentrates on illegal fee agreements between parties in interest or their respective attorneys. [See § 155.]

The two newly added sections, 156 and 157, expand the coverage of acts considered to be bankruptcy crimes. [*FN:* See id. §§ 156, 157.] The language of section 156 is quite extensive, providing for a fine or imprisonment in a bankruptcy case or related proceeding if a knowing attempt is made by "a bankruptcy petition preparer *in any manner* to disregard the requirement of title 11, United States Code, or the Federal Rules of Bankruptcy Procedure." [*FN:* 18 U.S.C. § 156 (emphasis added).] However, in contrast to the other sections, a "bankruptcy petition preparer" excludes attorneys and their employees. [See § 156(a) (defining "bankruptcy petition preparer" as "a person, other than the debtor's attorney or an employee of such an attorney, who prepares for compensation a document for filing").] Section 157 covers any fraud made in connection with a chapter 11 case or proceeding. [*FN:* See § 157.]

Since "fraud," by definition, involves the element of intent, courts investigate whether the debtor possessed the intent to defraud the creditors. [*FN:* See Citibank v. Eashai (*In re* Eashai), 87 F.3d 1082, 1089 (9th Cir. 1996) (stating that creditor seeking to have debt deemed nondischargeable under 11 U.S.C. § 523(a)(2)(A) must establish all elements of actual fraud, including intent); Carlisle Cashway v. Johnson (*In re* Johnson), 691 F.2d 249, 256 (6th Cir. 1982) (noting that intent must be established to prove fraud for nondischargeability of debt); Official Comm. of Unsecured Creditors v. Michelson (*In re* Michelson), 141 B.R. 715, 725 (Bankr. E.D. Cal. 1992) (finding that requisite intent in context of defective disclosure exists where there is intentional omission of material facts; specific intent to defraud not necessary); Aluminum Mills Corp. v. CitiCorp North Am. Inc. (*In re* Aluminum Mills Corp.), 132 B.R. 869, 885 (Bankr. N.D. Ill. 1991) (stating to find either "fraud in law" or "fraud in fact," court must find specific intent to defraud creditors); Mortgage Guar. Ins. Corp. v. Pascucci (*In re* Pascucci), 90 B.R. 438, 444 (Bankr. C.D. Cal. 1988) (finding that representation debtor makes with intent to deceive creditor, upon which creditor reasonably relies, and which results in damages, is fraudulent).] The difficulty of prebankruptcy asset planning is that activities done without a clear intent to file for bankruptcy may later be investigated as fraud on creditors. Although the Bankruptcy Code covers property that was transferred within one year before the date of the filing of the petition, [*FN:* See 11 U.S.C. § 548(a) (allowing bankruptcy trustee "to avoid any transfer of an interest of the debtor in property . . . that was made . . . on or within one year before the date of the filing of the petition").] the provisions governing fraud may extend well beyond that period. [*FN:* See infra notes 30−37 and accompanying text. But cf. Vermillion v. Scarbrough (*In re* Vermillion), 176 B.R. 563, 568 (Bankr. D. Or. 1994) (holding chapter 11 debtor in possession must establish fraudulent transfer was made within one year of filing, along with other elements, to have such transfer avoided under § 548); Harris v. Huff (*In re* Huff), 160 B.R. 256, 260 (Bankr. M.D. Ga. 1993) (stating that plaintiff seeking to avoid fraudulent conveyance must prove transfer was made within one year of petition); Roemelmeyer v. Gefen (*In re* Gefen), 35 B.R. 368, 370 (Bankr. S.D. Fla. 1984) (noting § 548 limits its application to transfers incurred within one year of filing).] For example, in *United States v. West,* [*FN:* 22 F.3d 586 (5th Cir.), *cert. denied* , 115 S.Ct. 584 (1994).] the court explicitly rejected the debtor's argument that transactions he conducted to apparently flout creditors were outside the jurisdiction of the Bankruptcy Code. [*FN:* See id. at 589.] West had been convicted on ten counts of bankruptcy fraud that stemmed from concealing assets in his bankruptcy case, and several counts of money laundering [*FN:* What constitutes money laundering is not only beyond the scope of this article, but also beyond the rational comprehension of at least one of the authors.] in connection with his acts to hide the proceeds, including putting money into his girlfriend's accounts. [See id. at 587.] The court affirmed his conviction for acts up to two years before filing, [See id. at 588 (citing 1988 transaction debtor was involved in even though debtor did not file for bankruptcy until 1990).] explaining that "[a] defendant may *knowingly and fraudulently* transfer property in contemplation of or with the intent to defeat the provision of Title 11 without necessarily transferring the property within one year before filing a bankruptcy petition." [*FN:* See id . at 590 (emphasis added).] This decision accords with the language of title 18 section 157, entitled "bankruptcy fraud," which does not set a specific time limit for crimes that can be punished. [*FN:* See 18 U.S.C. § 157(3) (1994).] The section specifically states that making a "false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under title 11, *at any time before or after the filing of the petition*, or in relation to a proceeding falsely asserted to be pending under such title, shall be fined under this title, imprisoned not more than 5 years, or both." [*FN:* See id. (emphasis added).]

1. Relying on Advice of Counsel ("My lawyer told me to do it!")

Although the focus of fraud charges is more frequently directed upon the debtor than his attorney, the latter may be subject to consequences for incorrectly advising a client. [*FN:* The only limits upon the types of transactions which might be implemented in a prebankruptcy planning context are the resourcefulness and creativity of clients and their advisors, including lawyers. Among these devices are (i) community property settlements where the nondebtor spouse obtains a division of liquid assets and other more demonstrably valuable properties while the prospective debtor spouse obtains illiquid assets such as minority interests in closely held corporations and partnerships; (ii) the creation of any variety of spendthrift or discretionary trusts, (iii) the transfer of asserts to partnerships or corporations in which the transferor retains a minority and noncontrolling position, (iv) conversion of nonexempt assets into exempt assets, or

(v) punitive squandering of the estate's assets as where the prospective debtor, facing an imminent bankruptcy, decides to spend all his money rather than allowing it to be available for distribution to creditors. See, *e.g.* , Thibodeaux v. Olivier (*In re* Olivier), 819 F.2d 550 (5th Cir. 1987) (finding potential malpractice claim against attorney under continuous concealment doctrine); United States v. Franklin, 837 F.Supp. 916, 920 (N.D. Ill. 1993) (warning that criminal liability would be forthcoming where attorney assists in concealing assets and filing fake Schedules and Statements of Financial Affairs).] Applicable ethical rules and prudent considerations in client counseling require that counsel not encourage or assist a client in any fraudulent transfer that has the purpose or effect of hindering, delaying or defrauding creditors. [*FN:* Thus incurring the wrath of the client. See Model Rules of Professional Conduct 1.2(d) (stating attorney shall not encourage or assist client in conduct that attorney knows is fraudulent).] This is a growing concern because debtors claim occasionally they relied on the advice of counsel, and therefore did not have the requisite intent under the fraud statutes. [*FN:* See Gregory E. Maggs , Consumer Bankruptcy Fraud and the "Reliance on Advice of Counsel" Argument , 69 Am. Bankr. L.J. 1 (1995).]

The consequences for both client and lawyer from aggressive prebankruptcy asset planning can be substantial. [*FN:* See Citibank v. Williams (*In re* Williams), 159 B.R. 648, 662 (Bankr. D.R.I. 1993) (denying debtor's discharge based on prepetition transfer of personal property to spouse during divorce proceeding); Aweida v. Cooper (*In re* Cooper), 150 B.R. 462, 467 (D. Colo. 1993) (precluding debtor's discharge by his prepetition transfers to wife with actual intent to defraud); Wootton v. Ravkino (*In re* Dixon), 143 B.R. 671, 679 (Bankr. N.D. Tex. 1992) (attorney's aggressive representation of debtor, which resulted in deletion of estate, might invoke government to assert RICO claim against debtor); March v. Sanders (*In re* Sanders), 128 B.R. 963, 969 (Bankr. W.D. La. 1991) (holding discharge is denied under continuing concealment doctrine when transfer of property is made more than one year before bankruptcy but with secretly retained interest in it).] For the client, the prospect of the denial of discharge looms large. [*FN:* See, *e.g.* , NCNB Tex. Nat'l Bank v. Bowyer (*In re* Bowyer), 916 F.2d 1056, 1058 (5th Cir. 1990), reh'g granted , 932 F.2d 1100 (5th Cir. 1991) (finding debtor's prepetition conversion of nonexempt assets to exempt assets precludes discharge).] Although Code section 727(a)(2) [*FN:* 11 U.S.C. § 727(a)(2) (1994).] focuses on transactions that occur within one year of the filing of bankruptcy, [*FN:* See 11 U.S.C. § 727(a)(2) (providing debtor's intent to hinder, defraud, or delay creditor by making fraudulent transfers within one year of bankruptcy will preclude debtor's discharge).] the continuing concealment doctrine [*FN:* See Rosen v. Bezner, 996 F.2d 1527, 1531 (3d Cir. 1993) (stating discharge is denied under "continuous concealment doctrine" even if initial act of concealment took place before the one year period, as long as debtor allowed property to be concealed into critical year); Thibodeaux v. Olivier (*In re* Olivier), 819 F.2d 550, 554 (5th Cir. 1987) (focusing on continuing concealment of interest in an asset which continued into year before bankruptcy); Jacobson v. Robert Speece Properties Inc. (*In re* Speece), 159 B.R. 314, 318 (Bankr. E.D. Cal. 1993) (stating concealment of interest in asset that continues, with requisite intent, into year before bankruptcy and such concealment is within reach of § 727(a)(2)(A)); Caughey v. Succa (*In re* Succa), 125 B.R. 168, 172 (Bankr. W.D. Tex. 1991) (stating debtor's active, deliberate, and consistent concealment of fraudulent transfers requires court to invoke continuing concealment doctrine).] may be applied, and asset planning more than one year prior to bankruptcy can have discharge implications for the client and potential malpractice implications for the attorney. [*FN:* See supra notes 30−37 (discussing defendant's liability for fraudulent transfers occurring longer than one year before filing petition).]

Creative Recreational Systems Inc. v. Rice (*In re* Rice) [*FN:* 109 B.R. 405 (Bankr. E.D. Cal. 1989).] serves as an example of asset planning that crossed over the line. In this case, the debtor consulted his attorney prior to filing regarding what to do with cash in his account. [*FN:* See id. at 407] The lawyer advised the client to "spend it." [*FN:* See id.] Relying upon the advice of counsel, the debtor withdrew cash from his account, gave some of the cash to his mother and spent the rest. [*FN:* See id.] In the subsequent bankruptcy case, an objection to discharge was filed under section 727(a)(2)(A) of the Bankruptcy Code. [*FN:* See id.] The debtor defended his actions on the grounds that he made the transfer without the requisite intent to hinder, delay, or defraud his creditors, because he was relying upon advice of counsel. [*FN:* See Rice , 109 B.R. at 408−09.] Although case law exists holding actual intent to hinder or delay can be justified by reliance upon the advice of counsel, that reliance must be in good faith. [*FN:* See, *e.g.* , Emmett Valley Assocs. v. Woodfield (In re Woodfield), 978 F.2d 516 (9th Cir. 1992) (stating debtor's reliance on prepetition discussion with individual who would become chapter 7 trustee did not save the debtor's discharge); First Beverly Bank v. Adeeb (*In re* Adeeb), 787 F.2d 1339 (9th Cir. 1986) (stating debtor's reliance must be in good faith).]

In *Rice*, the court rejected the reliance−on−counsel defense based on the finding that the debtor lacked good faith. The court observed:

A debtor who, intending to file bankruptcy, deliberately spends money for the sake of spending it lest the funds otherwise fall into the hands of the bankruptcy trustee and creditors is committing waste. [The action] has the ineluctable effect of hindering or delaying creditors. In such circumstance advice from a bankruptcy lawyer does not create a safe harbor. [*FN:* Rice , 109 B.R. at 408.]

Furthermore, the *Rice* court distinguished between what may have been legitimate exemption planning and flagrantly hiding behind the mask of "asset planning." [*FN:* See id.] The court observed that the circumstances in *Rice* far exceeded legitimate boundaries of converting nonexempt assets into exempt assets, the latter of which is arguably [*FN:* See discussion infra Part I.B.] consistent with the Code's fresh start policy for honest debtors. [*FN:* See *In re* Rice, 109 B.R. at 409.] However, the court noted that the policy of maximizing exemptions clashes with the policy of equitable distribution of the estate among creditors. [*FN:* See id. at 408.]

Not only does asset planning have potentially disastrous implications for the debtor, but an attorney who engages in prepetition asset planning may find himself facing a malpractice claim from the debtor if the discharge is denied, or from the bankruptcy trustee himself. [*FN:* See *In re* Tomailo, 205 B.R. 10, 13 (Bankr. D. Mass. 1997) (commenting that, in Massachusetts, most chapter 7 debtors' malpractice claims against former bankruptcy attorneys accrued from prepetition advice and services); Battley v. Pace (*In re* Pace), 132 B.R. 644, 645 (Bankr. D. Alaska 1991) (regarding chapter 7 debtor's legal malpractice claim arising out of attorney's failure to include liquor licenses in connection with debtor's prepetition sale).] For example, in *Eisenberg v. Resource Dynamics Inc. (In re* Environmental Research and Development), [*FN:* 46 B.R. 774 (S.D.N.Y. 1985).] a trustee sued the debtor's prepetition counsel for malpractice alleging that counsel assisted in structuring prepetition fraudulent transfers. [*FN:* See id. at 780.] Counsel sought to have the action dismissed for lack of subject matter jurisdiction and for failure to state a claim upon which relief could be granted. [*FN:* See id. at 776.] Denying the motion to dismiss, the court held that if the underlying transfers were fraudulent, the bankruptcy court had jurisdiction to consider the trustee's malpractice claim as well. [*FN:* See id. at 780.]

2. An Opportunity to Cure ("I didn't know *that* was illegal!")

There is a split of authority on the issue of whether a debtor can cleanse his wrongdoing by undoing the transfer before bankruptcy. [*FN:* Compare Martin v. Bajgar (*In re* Bajgar), 104 F.3d 495, 497 (1st Cir. 1997) (holding retransfer of fraudulently transferred property to chapter 7 debtor does not cure fraudulent transfer), with First Beverly Bank v. Adeeb (*In re* Adeeb), 787 F.2d 1339, 1345 (9th Cir. 1986) (holding debtor is not denied discharge if reveals fraudulent transfers to creditors, recovers fraudulent transfers before filing bankruptcy, and is otherwise qualified for discharge).] *In First Beverly Bank v. Adeeb* (*In re* Adeeb), [*FN:* 787 F.2d 1339 (9th Cir. 1986).] the creditor of an operator of several gas stations experiencing financial difficulties during a period of fluctuating gas prices demanded that the debtor−operator secure his debts with deeds of trust on his real property. [*FN:* See id. at 1341.] Faced with these threats, the debtor consulted an attorney with little or no bankruptcy experience. [*FN:* See id.] The attorney advised the debtor to transfer title to some of his real property without any consideration to third parties who could be "trusted." [*FN:* See id.] Relying on this advice, the debtor transferred title to several parcels of real property to friends and associates for no consideration, with beneficial interest at all times remaining with the debtor. [*FN:* See id.] As the debtor's financial condition continued to worsen, he finally sought advice from a bankruptcy attorney, who promptly advised him to reverse the transfers and disclose them to his creditors. [*FN:* See Adeeb , 787 F.2d at 1341−42.] After disclosing the transfers to his creditors, several of the debtor's trade creditors filed an involuntary petition against the debtor. [*FN:* See id.] Prior to the commencement of the bankruptcy proceeding, the debtor had recovered some but not all the property transferred. [*FN:* See id.] Not surprisingly, a creditor filed a complaint objecting to the debtor's discharge under Code section 727(a)(2). [*FN:* See id.] The bankruptcy court found that the debtor's discharge should be denied and the district court affirmed. [*FN:* See id.] The 9th Circuit, however, reversed and remanded, holding that a debtor who transfers property within one year of bankruptcy with the intent penalized by section 727 may not be denied discharge of his debts if he reveals the transfers to his creditors, recovers substantially all the property before he files bankruptcy, and is otherwise qualified for a discharge. [*FN:* See Adeeb , 787 F.2d at 1345; see also Logan v. Barney (*In re* Barney), 86 B.R. 105, 110−11 (Bankr. N.D. Ohio 1987) (stating no harm, no foul). But see Davis v. Davis (*In re* Davis), 911 F.2d 560, 562 (11th Cir. 1990) (taking restrictive interpretation of section 727, stating "Congress certainly was capable of drafting a statute which would deny discharge only when assets were fraudulently transferred and remained transferred at the time of filing of the bankruptcy proceeding, but did not").] A court's willingness to allow a debtor to rectify prepetition fraudulent transfers through disclosure and corrective action is limited to the extent that the disclosure must occur *before* discovery of the fraudulent transfers. [*FN:* See Smiley v. First Nat'l Bank (*In re* Smiley), 864 F.2d 562, 568 (7th Cir. 1989).]

B. Conversion of Nonexempt Assets into Exempt Assets

("But my cousin Leroy did it!")

Another area where bankruptcy attorneys may encounter ethical dilemmas involves one of the primary prebankruptcy planning tools: the conversion of nonexempt assets into exempt assets. [*FN:* See, *e.g.* , *In re* Allen, 203 B.R. 786, 792 (Bankr. M.D. Fla. 1996) (holding conversion of nonexempt assets into exempt assets done with intent to defeat interests of creditors may be sufficient to deny debtor's exemption);*In re* Swecker, 157 B.R. 694, 695 (Bankr. M.D. Fla. 1993) (holding conversion of nonexempt property into exempt property not per se fraudulent); Weissing v. Levine (*In re* Levine), 139 B.R. 551, 553 (Bankr. M.D. Fla. 1992) (holding debtor's prepetition conversion of nonexempt assets to exempt assets does not deprive debtor of right to claim assets exempt under state law);Federal Land Bank v. Ellingson (*In re* Ellingson), 63 B.R. 271, 279 (Bankr. N.D. Iowa 1986) (holding debtor's knowledge at conversion of nonexempt property to exempt property when about to file bankruptcy would not alone render such conversion fraudulent transfer).]The Bankruptcy Code allows a debtor to retain certain "exempt" property either under Code section 522(d), or under applicable state and federal law. [*FN:* See 11 U.S.C. § 522 (d) (1994) (providing list of exempt properties).] If the Bankruptcy Code and applicable local laws do not prohibit conversion of nonexempt assets to exempt assets, there should be nothing ethically wrong with an attorney counseling and assisting this kind of prebankruptcy asset planning. To understand the ethical boundaries of asset planning, one must examine the case law dealing with "exemption planning." [*FN:* See supra note 77 and accompanying text.]

Based on the legislative history of Code section 522, it is clear that Congress contemplated the conversion of nonexempt property to exempt property prior to filing for bankruptcy. [*FN:* See, *e.g.* , *In re* Spoar−Weston, 139 B.R. 1009, 1014 (Bankr. N.D. Okla. 1992) (noting committee report has been cited as proof of Congressional intent to allow bankruptcy planning no matter how inequitable it may be);*In re* Holt, 84 B.R. 991, 1008 (Bankr. W.D. Ark. 1988) (noting Congress contemplated conversions of nonexempt assets to exempt assets in enacting the Code); Oberst v. Oberst (*In re* Oberst), 91 B.R. 97, 99 (Bankr. C.D. Cal. 1988) (noting congressional intent that prospective debtor may take full advantage of exemptions by converting nonexempt assets to exempt assets).]Both the House and Senate reports state:

As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors and permits the debtor to make full use of the exemptions to which he is entitled under the law. [*FN:* S. R ep. No. 95−989, at 76 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5862; H.R . Rep. No. 95−595, at 361 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6317.]

The rationale behind the provision is to allow exemptions where the result would otherwise be extremely harsh to debtors, especially in those jurisdictions where the exemption allowance is minimal. [*FN:* See 4 Collier on Bankruptcy , ¶ 522.08 [4], at 522−46 (Lawrence P. King *et al.* eds., 15th ed. rev. 1996) (stating Code adopts position that will protect debtors who are not allowed to convert nonexempt property into exempt property in their jurisdictions).] Nonetheless, courts are not reluctant to deny exemptions if there is extrinsic evidence of actual intent to defraud and if the state law permits disallowance of the exemption for fraud. [*FN:* See id. ¶ 522.08 [4], at 522−43 (stating courts finding debtor's intent to defraud may deny discharge).] The case law regarding the issue of conversion of nonexempt property into exempt assets follows Congress' apparent intent to permit the conversion of nonexempt to exempt property even if it had the effect and purpose of placing the property out of the reach of creditors. [*FN:* See Norwest Bank Nebraska, N.A. v. Tveten, 848 F.2d 871, 873 (8th Cir. 1988); see also Armstrong v. Lindberg (*In re* Lindberg), 735 F.2d 1087, 1090 (8th Cir.) (permitting debtor to exempt property from creditors either pursuant to provision of Code or state law), *cert. denied* , 469 U.S. 1073 (1984); First Tex. Sav. Ass'n v. Reed (*In re* Reed), 700 F.2d 986, 991 (5th Cir. 1983) (requiring proof of actual intent to deny discharge).]

Creditors' challenges to a debtor's conversion of nonexempt property into exempt property prior to filing for bankruptcy have taken a variety of forms. These attacks have manifested themselves as objections to discharge, objections to exemptions claimed, motions to dismiss the bankruptcy case, attachments of liens, and avoidance as fraudulent or preferential transfers. [*FN:* See generally 11 U.S.C. § 523(a)(2) (1994) (stating false pretenses, false representations, or actual fraud may result in denial of discharge); 11 U.S.C. § 547(b) (stating preferential transfers may be avoided); 11 U.S.C. § 727 (a) (1994) (stating discharge may be denied based on debtor's concealment, destruction, or failure to maintain assets of estate).]The main vehicle creditors have used is the objection to the debtor's discharge pursuant to Code section 727, [*FN:* 11 U.S.C. § 727.] and it is these cases that are most instructive in defining the limits of proper exemption planning. [*FN:* See, *e.g.* , Panuska v. Johnson (*In re* Johnson), 880 F.2d 78, 81 (8th Cir. 1989) (noting desire to convert assets into exempt forms in itself does not constitute fraud), remanded , 124 B.R. 290 (Bankr. D. Minn. 1991); Barnett Bank v. Decker (In re Decker), 105 B.R. 79, 83 (Bankr. M.D. Fla. 1989) (finding no basis for denial of discharge under § 727 (a) (2) where debtor converted assets shortly before bankruptcy); Cristol v. Blum (In re Blum), 41 B.R. 816, 819 (Bankr. S.D. Fla. 1984) (finding of no fraud where debtor transferred nonexempt assets by using proceeds from sale to purchase exempt assets).]

These cases uniformly recognize the debtor's right to convert nonexempt property into exempt property prior to the filing for bankruptcy, reasoning that mere conversion is not to be considered fraudulent, nor grounds for barring a debtor's discharge. [*FN:* See, *e.g.* , Johnson , 880 F.2d at 81 (recognizing "law permits debtors to intentionally transform property into exempt assets"); Ford v. Poston (*In re* Ford), 773 F.2d 52, 54 (4th Cir. 1985) (reasoning "[m]ere conversion of property from nonexempt to exempt on the eve of bankruptcy−−even though the purpose is to shield the asset from creditors−−is not enough to show fraud"); First Tex. Sav. Assoc. Inc. v. Reed (*In re* Reed), 700 F.2d 986, 990 (5th Cir. 1983) (reasoning "mere conversion [of nonexempt assets into exempt assets] is not to be considered fraudulent unless other evidence proves actual intent to defraud creditors"); Decker , 105 B.R. at 83 (permitting conversion of nonexempt assets into exempt assets before filing petition); Blum , 41 B.R. at 817 (concluding mere conversion of nonexempt assets into exempt assets not prohibited by Bankruptcy Code absent actual fraudulent intent). See generally Alan N. Resnick, Prudent Planning or Fraudulent Transfer? The Use of Nonexempt Assets to Purchase or Improve Exempt Property on the Eve of Bankruptcy, 31 Rutgers L. Rev. 615 (1978); s ee also supra note 75 and accompanying text (discussing congressional intent with respect to this conversion practice).] The key issue in these cases is whether the debtor possessed *actual intent* to hinder, delay, *or* defraud creditors so as to exceed proper conversion. [*FN:* See Finalco Inc. v. Roosevelt (*In re* Roosevelt), 87 F.3d 311, 317 (9th Cir. 1996) (noting "one of the principal points of focus in litigation involving [Code section 727 (a) (2)] involves certain conduct coupled with an appropriate guilty state of mind"); Equitable Bank v. Miller (*In re* Miller), 39 F.3d 301, 307 (11th Cir. 1994) (deciding whether debtor possessed requisite "actual intent to defraud" to warrant denial of discharge); Wines v. Wines (*In re* Wines), 997 F.2d 852, 856 (11th Cir. 1993) (reasoning evidence of actual wrongful intent necessary to deny discharge); Reed, 700 F.2d at 991 (reasoning "mere conversion is not to be considered fraudulent unless other evidence proves actual intent to defraud creditors").] The intent must be actual, and not implied or presumed in law, so implied or constructive intent will not suffice. [*FN:* See Miller , 39 F.3d at 306 (arguing constructive fraud will not support denial of discharge); Lovell v. Mixon, 719 F.2d 1373, 1376−77 (8th Cir. 1983) (concluding constructive intent cannot be basis for the denial of discharge in bankruptcy); Bank of Penn. v. Adlman (*In re* Adlman), 541 F.2d 999, 1003 (2d Cir. 1976) (reasoning constructive fraudulent intent will not suffice to deny discharge under section 14(c) of Bankruptcy Act, precursor to Code section 727 (a) (2)). But see Future Time Inc. v. Yates, 26 B.R. 1006, 1007 (M.D. Ga. 1983) (reasoning "actual intent may be inferred from the actions of the debtor").] Furthermore, the fact that property is transferred for less than appraised value is not automatically equivalent to hindering or delaying creditors. One court specifically recognized that the creditor "was, in effect, exchanging a liquid asset for an illiquid one, . . . [and] there were declining property values at the time." [*FN:* See Miller , 39 F.3d at 307; see also *In re* Wines , 997 F.2d at 856 (concluding undervaluation of claim alone did not warrant denial of discharge).]

Case law consistently recites the axiom that the mere conversion of nonexempt assets to exempt assets is not to be considered fraudulent, nor grounds for barring a debtor's discharge under Code section 727(a)(2)(A). [*FN:* See Marine Midland Bus. Loans Inc. v. Carey (*In re* Carey), 938 F.2d 1073, 1077 (10th Cir. 1991) (reasoning absent extrinsic evidence of fraudulent intent, mere conversion will not support denial of discharge); Moreno v. Ashworth (*In re* Moreno), 892 F.2d 417, 419 (5th Cir. 1990) (finding actual intent to defraud creditors condition precedent to denial of discharge); Norwest Bank Neb., N.A. v. Tveten, 848 F.2d 871, 874 (8th Cir. 1988) (finding "absent extrinsic evidence of fraud, mere conversion of nonexempt property to exempt property is not fraudulent as to creditors even if the motivation behind the conversion is to place those assets beyond the reach of creditors"); Ford , 773 F.2d at 54 (concluding mere conversion of nonexempt assets into exempt assets on the eve of bankruptcy filing will not prove fraud); First Tex. Sav. Ass'n v. Reed (*In re* Reed), 700 F.2d 986, 991 (5th Cir. 1983) (finding "mere conversion is not to be considered fraudulent unless other evidence proves actual intent to defraud").] Unless other evidence proves actual intent to hinder, delay, or defraud creditors, the exemption planning will not result in a denial of discharge. For example, the 5th Circuit significantly narrowed the scope of permitted behavior in its original opinion in NCNB Texas National Bank v. Bowyer (*In re Bowyer*) ("Bowyer I"). [*FN:* 916 F.2d 1056, 1060 (5th Cir. 1990) (finding district court erred in allowing debtor discharge because, while debtor may not have had intent to defraud, debtor had intent to hinder and delay creditor), aff'd on reh'g , 932 F.2d 1100 (5th Cir. 1991); s ee also FDIC v. Morris (*In re* Morris), 51 B.R. 462, 464 (Bankr. E.D. Tenn. 1985) (reasoning that since statute is disjunctive proof of intent to hinder or delay will suffice in absence of proof of intent to defraud); *In re* Perlumutter, 256 F. 862, 869 (D.N.J. 1919), aff'd sub nom. Perlmutter v. Hudspeth, 264 F. 957 (3d Cir. 1920) (reasoning intent to hinder and delay is sufficient to support denial of discharge under Bankruptcy Act section 14(b), precursor to Bankruptcy Code section 727(a)(2)).] On rehearing ("Bowyer II"), the court withdrew *Bowyer I*, but left open the door to challenge a debtor's discharge on grounds that the debtor intended to hinder and delay its creditors by converting its assets. [*FN:* See Bowyer II , 932 F.2d at 1102−03 (affirming district court's conclusion that debtor's actions constituted "legitimate prebankruptcy planning" and, therefore, foreclosing necessity of addressing issue of whether debtor possessed non−fraudulent intent to hinder and delay his creditors).]

Prior to *Bowyer I*, one of the leading cases on the conversion of nonexempt assets to exempt assets was *In re Reed.* [*FN:* 700 F.2d at 986.] In *Reed*, the 5th Circuit Court of Appeals concluded that the debtor, Reed, deserved to lose his discharge after obtaining a year−long moratorium from his creditors and used the time to convert nonexempt assets into exempt assets. [*FN:* See id . at 991−92.] Reed's conduct was so egregious that the court's conclusion that he intended to defraud his creditors seemed sound. [*FN:* See id. at 991 (concluding Reed's whole pattern of conduct evinces actual intent to defraud).] However, the question of whether less egregious conduct would be interpreted as evidence of "actual" intent to defraud creditors remained open.

In *Bowyer I*, the 5th Circuit reversed the lower courts' rulings granting Dr. Bowyer's discharge. [*FN:* See Bowyer I , 916 F.2d at 1060.] Although the court affirmed the lower courts' findings that Dr. Bowyer had not shown an actual intent to *defraud* his creditors, it reversed the judgment because Dr. Bowyer's conduct evidenced an intent to "hinder and delay" his creditors. [*FN:* See id. (finding "spending spree and . . . satisfaction of his homestead mortgage" support finding of actual intent).] By focusing on the intent to hinder and delay creditors rather than the intent to defraud, the 5th Circuit diverged from previous case law and clearly suggested that debtors may lose their discharge for actions far less egregious than those undertaken by Reed. In *Bowyer I*, the court implied that any significant conversion of assets and any extravagant personal spending in the year prior to bankruptcy could support a finding of intent to hinder and delay creditors and a consequent loss of discharge. [*FN:* See id.]

On rehearing, the 5th Circuit significantly concluded that it had not shown proper deference to the lower courts in its previous ruling. [*FN:* See Bowyer II, 932 F.2d at 1101.] The bankruptcy court and district court had found that Dr. Bowyer did not have plans to file bankruptcy at the time he converted some of his nonexempt assets to exempt assets. [*FN:* See id. at 1101−02.] The court concluded that this finding by the lower courts was adequately supported by the record because of a particularly significant piece of evidence. [*FN:* See id. at 1102.] During the period when Dr. Bowyer was converting assets, he also made an advance payment of $25,000 to his primary creditor. [*FN:* See id.] The court found that it was reasonable for the bankruptcy court to conclude that Dr. Bowyer did not intend to file bankruptcy at the time. [See id. at 1102.] On the issue of whether the debtor had intended to hinder or delay creditors, the court found that the creditor had not raised these arguments at the bankruptcy court level. [*FN:* See Bowyer II , 932 F.2d at 1102 .] The court did not remand the case for such a finding because the court determined that the $25,000 payment to the creditor was inconsistent with an intent to hinder and delay. [*FN:* See id.]

The *Bowyer* decisions open the door for creditors to challenge a debtor's prebankruptcy planning merely on the grounds that the debtor intended to hinder, delay, or defraud creditors. Arguably, all bankruptcy planning is done with the intent to hinder and delay creditors. What other logical purpose could such planning possibly serve? Therefore, the ethical issue of which attorneys must be aware hinges upon the client's motivation in making the conversions. [*FN:* See id. at 1101 (concluding debtor's unscheduled advance payment of $25,000 on his note was incompatible with intent to default on note); Bowyer I, 916 F.2d at 1058 (finding debtor's conduct violative of Code section 727 (a) and reasoning it was not debtor's placing assets beyond reach of creditors that rendered debtor's conduct violative, but debtor's intent in doing so).] The greater the number and amount of the conversions and the closer in time to the filing date (or the degree of certainty that a bankruptcy proceeding will be necessary), the greater the risk that a court reviewing the asset conversions will conclude that they were done with sufficient wrongful intent. [*FN:* See Dolese v. United States, 605 F.2d 1146, 1154 (10th Cir. 1979) (stating "[t]here is a principle of too much; phrased colloquially, when a pig becomes a hog it is slaughtered."); see also Swift v. Bank of San Antonio (*In re* Swift), 3 F.3d 929, 931 (5th Cir. 1993) (employing "pig to hog" argument in drawing line between legitimate prebankruptcy planning and intentionally defrauding creditors); Bowyer I , 916 F.2d at 1060 (explaining "[pig to hog] analysis recognizes that while some prebankruptcy planning is appropriate, the wholesale expenditure of nonexempt assets on the eve of bankruptcy, including conversions to exempt assets . . . may not be.").] Furthermore, to the extent counsel assists a client in making such transfers, then he or she may have stepped over the boundaries into ethical misconduct. [*FN:* A lawyer must not "[e]ngage in conduct involving dishonesty, fraud, deceit, or misrepresentation." Model Code of Professional Responsibility DR 1−102 (a)(4) (1980). It is considered professional misconduct where a lawyer engages in such conduct. See Model Rules of Professional Conduct Rule 8.4 (c) (1983).]

Unfortunately for the attorney, there remains much uncertainty in advising debtors engaged in prebankruptcy planning. [*FN:* See Swift , 3 F.3d at 931 (finding "line between legitimate prebankruptcy planning and intent to defraud creditors contrary to § 727 (a) (2) is not clear"); Panuska v. Johnson (*In re* Johnson) , 880 F.2d 78, 81 (8th Cir. 1989) (recognizing "separating ordinary prebankruptcy planning from fraudulent action is difficult.")] As shown in *Bowyer I & Bowyer II*, courts can have a difficult time in deciding how many transfers are too many. [*FN:* See Bowyer II, 932 F.2d at 1101 (concluding it had not given proper deference to bankruptcy court's findings, 5th Circuit reversed its earlier rulings in Bowyer I on rehearing in Bowyer II).] Another example of this uncertainty can be found where two debtors, represented by the same attorney, undertook very similar prebankruptcy transfers as a result of debts to the same creditor. [*FN:* See Johnson , 880 F.2d at 78; Norwest Bank Neb., N.A. v. Tveten, 848 F.2d 871 (8th Cir. 1988).] In one instance, the bankruptcy court's denial of the debtor's discharge was affirmed by the district court and the 8th Circuit. [*FN:* See Tveten , 848 F.2d at 877.] In the other instance, both the bankruptcy court and district court allowed the discharge until the 8th Circuit reversed and remanded the case. [*FN:* See Johnson , 880 F.2d at 84.] That debtor ultimately lost his discharge. [*FN:* See Panuska v. Johnson (*In re* Johnson), 124 B.R. 290, 297 (Bankr. D. Minn. 1991) (concluding denial of discharge, while entirely contrary to earlier decision, is unavoidable).] When courts can have such varying results on almost identical facts, the entire area of law obviously lacks certainty and serves as a warning to debtors and their attorneys to play on the safe side.

Because of such variation in court decisions, the asset planning area is fraught with dangers and risks to both client and lawyer. Therefore, the prudent course for attorneys to take is to err on the side of caution which is far preferable to the consequences of erring on the side of risk. [*FN:* The colloquialism for this principle is the "Pig Rule: that when a pig becomes a hog, it is slaughtered." Swift v. Bank of San Antonio (*In re* Swift), 3 F.3d 929, 931 (5th Cir. 1993). In Swift , the debtor's repayment of alimony and car loans, the tranferring money to and from relatives and the underreporting assets rendered him a hog and the court denied his discharge. *Id.*]

II. PROBLEMS OF DIVIDED LOYALTY

(Only Schizophrenics Need Apply)

A. The Basics

The consequences of the failure to check for conflicts in connection with bankruptcy cases cannot be overstated. [*FN:* See, *e.g.* ,*In re* Kendavis Indus. Int'l Inc., 91 B.R. 742, 762 (Bankr. N.D. Tex. 1988) (disallowing fees where attorney was not "disinterested" within meaning of Bankruptcy Code).] In undertaking representation, particularly in chapter 11 cases, counsel must meet the requirements of section 327 of the Code, which specifically proscribe conflicts of interest. [*FN:* See 11 U.S.C. § 327 (a) (1994) "[T]he duty explicitly imposed on the bankruptcy court by § 327 . . . demands that the court root out all impermissible conflicts of interest between attorney and client."*In re* Martin, 817 F.2d 175, 180 (1st Cir. 1987). Code section 327 has been described as a "prophylactic provision designed to insure that the undivided loyalty and exclusive allegiance required of a fiduciary to an estate in bankruptcy is not compromised or eroded."*In re* Prudent Holding Corp., 153 B.R. 629, 631 (Bankr. N.D. Ill. 1990). Therefore, Code section 327 mandates all appointed attorneys "tender undivided loyalty and provide untainted advice and assistance in furtherance of their responsibilities." Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir. 1994); see also *In re* Grabill Corp., 113 B.R. 966, 970 (Bankr. N.D. Ill. 1990) (noting "[c]ounsel for a chapter 11 debtor owes a fiduciary duty to the corporation or partnership as an entity").] Section 327 sets forth a two−part test to determine whether an attorney may act as counsel for the debtor: (i) counsel may not represent any interest materially adverse to the estate, and (ii) counsel must be disinterested. [*FN:* See 11 U.S.C. § 327(a). Code section 327 (a) provides that "the trustee, with the court's approval, may employ one or more attorney, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate." See id.] The requirements are distinct although courts often confuse them. The "adverse interest" requirement is a fairly familiar conflict rule that applies to all lawyers. [*FN:* See Model Rules of Professional Conduct Rule 1.7 (1983) (stating general rule that lawyer shall not represent client if representation of client will be directly adverse to another client or if representation may be materially limited by lawyer's responsibilities to another client, third person, or lawyers own interest.); N.Y. D.R. 5−101, 5−105 (same); Cal. Rules of Professional Conduct Rule 3−310 (C) (1996) (same).] The "disinterestedness"

requirement is a term of art defined in section 101(14). [*FN:* See 11 U.S.C. § 101(14) (1994).] It doesn't mean that the professional is bored with the representation.

In business reorganization cases, these problems of real (or potential) divided loyalties arise in a number of contexts. [*FN:* See infra notes 124−31 and accompanying text.] Among the more common ethical problems of divided loyalty are: (i) simultaneous representation of multiple creditors in the same case; [*FN:* See, *e.g.* , City of Lafayette v. Oklahoma P.A.C. First Ltd. Partnership (*In re* Okla. P.A.C. First Ltd. Partnership), 122 B.R. 387, 389−94 (Bankr. D. Ariz. 1990) (considering simultaneous representation of five individual creditors).] (ii) representation of a creditor or creditors and an official creditors committee; [*FN:* See, e.g ., *In re* Calabrese, 173 B.R. 61, 63 (Bankr. D. Conn. 1994) (sustaining trustee's objection to application of official unsecured creditors' committee seeking retroactive employment of counsel where counsel represented secured creditors on unrelated matters);*In re* Grant Broadcasting Inc., 71 B.R. 655, 660−64 (Bankr. E.D. Pa. 1987) (considering simultaneous representation of unsecured creditor and official unsecured creditors' committee);*In re* Codesco Inc., 18 B.R. 997, 1001 (Bankr. S.D.N.Y. 1982) (denying creditor's motion objecting to trustee's application to retain law firm in chapter 7 case where firm formerly represented creditors' committee in aborted chapter 11 case).] (iii) simultaneous or successive representation of a creditor and the debtor in the same case; [*FN:* See, e.g ., Humble Place Joint Venture v. Fory (*In re* Humble Place Joint Venture), 936 F.2d 814, 818−19 (5th Cir. 1991) (considering simultaneous representation of creditor and debtor in same bankruptcy proceeding).] (iv) representation of the debtor in the bankruptcy case and of the creditor(s) of the debtor in other unrelated cases or on unrelated matters; [*FN:* See, e.g .,*In re* American Printers &

Lithographers Inc., 148 B.R. 862, 867 (Bankr. N.D. Ill. 1992) (denying debtor's application to employ counsel where counsel's representation of creditor in other matters created actual conflict requiring disqualification);*In re* Amdura Corp., 121 B.R. 862, 863−64 (Bankr. D. Colo. 1990) (considering counsel's representation of six debtor entities and counsel's former and successive representation, albeit on unrelated matters, of principal creditor);*In re* Status Game Corp., 102 B.R. 19, 21 (Bankr. D. Conn. 1989) (denying debtor's application to retain its regular prepetition counsel where counsel represented debtor's principal secured creditor both prepetition and postpetition);*In re* Lee Way Holding Co., 100 B.R. 950, 962 (Bankr. S.D. Ohio 1989) (granting creditor's motion to disqualify debtor's counsel and require disgorgement of fees where counsel represented creditor prepetition and continued professional relationship postpetition).] (v) payment of debtor counsel fees by a third party; [*FN:* See, e.g.,*In re* Rabex Amuru Inc., 198 B.R. 892, 897−98 (Bankr. M.D.N.C. 1996) (granting motion to remove debtor's counsel where firm's fees paid by creditor);*In re* Missouri Mining Inc., 186 B.R. 946, 950 (Bankr. W.D. Mo. 1995) (denying trustee's motion to vacate order authorizing employment of debtor's counsel where counsel's retainer was paid by debtor's principal, who was also a creditor, because counsel found disinterested);*In re* Hathaway Ranch Partnership, 116 B.R. 208, 219 (Bankr. C.D. Cal. 1990) (finding payment of debtor's counsel by third party creates actual conflict of interest warranting disqualification);*In re* Crimson Invs., N.V., 109 B.R. 397, 403 (Bankr. D. Ariz. 1989) (ordering surrender of entire retainer received by debtor's counsel where retainer paid by debtor's largest unsecured creditors).] (vi) representation of multiple affiliates; [*FN:* See, *e.g.* , W.F. Dev. Corp. v. Office of United States Trustee (*In re* W.F. Dev. Corp.), 905 F.2d 883, 884 (5th Cir. 1990) (concluding simultaneous representation of general partner and limited partners creates incurable conflict of interest), cert . denied , 499 U.S. 921 (1991);*In re* Renfrew Ctr. Inc., 195 B.R. 335, 342 (Bankr. E.D. Pa. 1996) (granting application of two related corporate debtors to retain same law firm as counsel in respective chapter 11 cases where no impermissible conflict of interest found);*In re* Interstate Distribution Ctr. Assocs. (A), Ltd., 137 B.R. 826, 834−35 (Bankr. D. Colo. 1992) (finding counsel's representation of corporate debtor and its related entities created impermissible conflict of interest precluding law firm's employment as debtor's counsel).] (vii) the problem created by the necessity that counsel for a corporate debtor take its direction from management, which itself may not be governed by the disinterestedness requirement; [*FN:* For example, management may be shareholders of the debtor, guarantors of the debtor's, liable on tax liabilities of the debtor, or may owe their livelihoods and employment to their continued relationship to the debtor. See e.g.,*In re* Best W. Heritage Inn Partnership, 79 B.R. 736 (Bankr. E.D. Tenn. 1987).] and (viii) simultaneous representation of two unsecured creditors' committees of economic competitors. [See, e.g.,*In re* Caldor Inc., 193 B.R. 165, 181−82 (Bankr. S.D.N.Y. 1996) (overruling trustee's motion objecting to law firm's retention by creditors' committee where counsel simultaneously represented creditors' committee in chapter 11 case of debtor's competitor).] The issue underlying each of these considerations is whether the court in fact looks to actual conflicts or potential conflicts.

B. Actual Versus Potential Conflicts ("Let's wait and see what happens")

Under the Bankruptcy Code, as in other areas of law, attorneys are not allowed to represent a person when there are conflicts, unless the clients have agreed to such representation. [*FN:* See 11 U.S.C. § 327. "[T]he duty explicitly imposed on the bankruptcy court by § 327 . . . demands that the court root out all impermissible conflicts of interest between attorney and client."*In re* Martin, 817 F.2d 175, 180 (1st Cir. 1987). Bankruptcy courts have also been held to have the inherent power to sanction attorneys for violations of professional canons, notwithstanding the absence of express statutory authority. See Barton v. Chrysler (*In re* Paine), 14 B.R. 272, 275 (W.D. Mich. 1981). Generally, the lawyer may only represent a client whose interests are directly adverse to those of another client if each client has consented after consultation. See Model Rules of Professional Conduct Rule 1.7 (a) (1983). Further, the lawyer may only represent a client whose interests are "materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests" after each client has consented after consultation. S ee id.]

A number of courts that have struggled with the practicalities and potential inefficiencies of multiple lawyers representing closely affiliated entities have fashioned a distinction between actual and potential conflicts. [*FN:* See, e.g.,*In re* Global Marine Inc., 108 B.R. 998, 1002 (Bankr. S.D. Tex. 1987) (finding that while dual representation might rise to level of potential conflict; it does not, in and of itself, reach the disqualifying level of actual conflict);*In re* Martin, 817 F.2d at 181 (reasoning that while actual conflict will generally be disabling, no such per se rule may be applied where mere potential conflict exists).] Other courts have determined that such a distinction is unrealistic. [*FN:* See infra Part I.B.1.]

1. Court rejecting potential−actual dichotomy

In *In re Kendavis Industries International*, [*FN:In re* Kendavis Indus. Int'l Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988).] the court rejected the notion that counsel ceases to be disinterested only when a potential conflict becomes actual. [*FN:* See id. at 754.] The court held that a conflict is present "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 control party, to protect the interest of that party." [*FN:* See id .] The court further characterized the situation as an "actual" conflict beginning at the date the representation commenced. [*FN:* See id.] This holding would equally apply to counsel representing partnerships that also had "some agreement, whether expressed or implied, with the general or limited partners, or with any control person, to protect its interest." [*FN:* See id.] An attorney in such a situation would be subject to disqualification and a disallowance of fees. [See Kendavis , 91 B.R. at 754.] The *Kendavis* court saw the concept of "potential" conflicts as "a contradiction in terms," noting that "[o]nce there is a conflict it is *actual−−not potential*." [*FN:* See id. (emphasis added); see also *In re* Global Marine Inc., 108 B.R. 998, at 1006−07 (Bankr. S.D. Tex. 1987) (requiring actual conflict and therefore allowing law firm to represent parent holding company and subsidiaries despite existence of intercompany debt);*In re* Philadelphia Athletic Club Inc., 20 B.R. 328, 337−38 (Bankr. E.D. Pa. 1982) (disqualifying all members of law firm even though no actual conflict of interest).]

The fallacy of a distinction between actual and potential conflicts was more recently illustrated in *In re BH & P Inc.*, [*FN:* 103 B.R. 556 (Bankr. D.N.J. 1989), aff'd , 949 F.2d 1300 (3d Cir. 1991).] where the court rejected the notion that actual and potential conflicts should be treated differently. [*FN:* See id. at 563−64.] Pointing out that a potential conflict could "exert a subtle influence over the manner in which events develop to set the stage for an active competition," the court emphasized that by the time a so−called "potential conflict" becomes "actual," the damage might be done already. [*FN:* See id. at 564.] The court stated:

To put it more bluntly, the existence of a "potential" conflict can change circumstances so that the deck is stacked by the time the conflict becomes "actual." Secondly, when a "potential" conflict does become "actual" the court is faced with the difficulty and delay attendant upon disqualification of trustees and professionals in midstream. This can cause serious problems which could have been avoided if a professional without a "potential" conflict had been employed from the outset. [*FN:* See id .; see also *In re* Paolino, 80 B.R. 341, 345 (Bankr. E.D. Pa. 1987). C.R.P.C. 3−310(C) recognizes both potential and actual conflicts and requires the attorney to obtain the informed written consent of each client prior to continuing or undertaking the representation of both clients. See id. Furthermore, the 9th Circuit Court of Appeals has approved the employment of counsel or special counsel even if a potential conflict might arise so long as the bankruptcy court retains the power to remove counsel if the potential conflict becomes an actual conflict. See Security Pac. Bank Wash. v. Steinberg (In re Westwood Shake & Shingle Inc.), 971 F.2d 387, 390 (9th Cir. 1992).]

This issue was taken to new heights when the 1st Circuit stated that a ruling from the bankruptcy court should be obtained "as soon as counsel acquires even constructive knowledge reasonably suggesting an actual or potential conflict." [*FN:* See Rome v. Braunstein, 19 F.3d 54, 59 (1st Cir. 1994).] The court did not elaborate on how one could disclose constructive knowledge of a potential conflict, but it did warn that those failing to make a timely and complete disclosure "proceed at their own risk." [*FN:* See id .]

In a recent high profile case in the Southern District of New York, Bankruptcy Judge Tina Brozman suggested that instead of focusing on the potential/actual dichotomy, the court should employ the following test:

[W]hether a professional has "either meaningful incentive to act contrary to the best interests of the estate and its sundry creditors−−an incentive sufficient to place those parties at more than acceptable risk or the reasonable perception of one." In other words, if it is plausible that the representation of another interest may cause the debtor's attorneys to act any differently than they would without that other representation, then they have a conflict and an interest adverse to the estate. [*FN:* See In re Leslie Fay Cos. Inc., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994) (quoting*In re* Martin, 817 F.2d 175, 180 (1st Cir. 1987)).]

As a caveat, attorneys should recognize that waiting until an "actual" conflict appears can cause severe economic consequences. In *Leslie Fay*, for example, Weil Gotshal's failure to disclose potential and actual conflicts reportedly cost the firm approximately $1 million. [*FN:* See id. at 530.]

2. Courts adopting potential−actual dichotomy

In contrast to *Kendavis* and *BH & P*, other courts have adopted an approach to conflicts that attempts to adjust the practical realities to the requirements of the Bankruptcy Code. [*FN:* See, e.g., Leslie Fay , 175 B.R. at 539 (allowing counsel to remain in case "in effort to reconcile the twin concerns of preserving the integrity of the bankruptcy process and the viability of the reorganization case");*In re* Global Marine Inc., 108 B.R 998, 1008 (Bankr. S.D. Tex. 1987) (considering "orderly administration of the debtors' bankruptcy proceedings" and possibility of debtors incurring "unnecessary expense" in concluding disqualification not appropriate remedy for potential conflict of interest);*In re* Chamberlin Corp., 53 B.R. 764, 767 (Bankr. M.D. Fla. 1985) (allowing counsel to simultaneously represent debtor in possession and interested party in order to avoid duplication of services and waste of assets);*In re* O.P.M. Leasing, 16 B.R. 932, 938 (Bankr. S.D.N.Y. 1982) (finding premature prophylactic action results in confusion and interruption of orderly administration of bankruptcy cases and incurs greater expense).] These cases make a distinction between potential and actual conflicts and decline to use a bright line rule of disqualification. [*FN:* See Leslie Fay , 175 B.R. at 532. "The more difficult area is when a live conflict of interest has not quite emerged, yet the factual scenario is sufficiently susceptible to that possibility so as to make the conflict more than merely 'hypothetical or theoretical.'" *Id.* Several courts have declined to sanction firms falling into this "scumbled" middle ground. See, e.g., *In re* Martin , 817 F.2d 175, 180 (1st Cir. 1987). The 1st Circuit Court of Appeals declined to sanction a law firm where a potential conflict of interest, that had not become actual, existed. See Martin , 817 F.2d at 181. In Martin, the 1st Circuit found the bankruptcy court had improperly applied an inflexible per se rule against potential conflicts of interest. See id. at 183. Judge Selya reasoned that while actual conflicts will generally be disabling, there should be no similar per se rule against potential conflicts. See id. at 181. Judge Selya stated, "[t]he naked existence of a potential conflict of interest does not render the appointment of counsel nugatory, but makes it voidable as the facts may warrant." See id .; see also Global Marine , 108 B.R. at 1006 (requiring actual conflict in order to necessitate denial or reduction of fees); H&K; Devs. v. Waterfall Village, Ltd. (*In re* Waterfall Village, Ltd.), 103 B.R. 340, 344−45 (Bankr. N.D. Ga. 1989) (implying anything short of "specifically identifiable impropriety" will not result in disabling conflict of interest).] These courts will not disqualify established representation over affiliated or related corporations without a showing of an actual, present conflict incapable of any other equitable resolution. [*FN:* See, *e.g.* , Martin , 817 F.2d at 182 (holding existence of potential for conflict of interest renders appointment of counsel "voidable as the facts may warrant"); In re Star Broadcasting Inc., 81 B.R. 835, 844 (Bankr. D.N.J. 1988) (reasoning "it would be unreasonable and unnecessarily cumbersome to always require different counsel in related chapter 11 cases, however, whether such an actual disqualifying conflict exists must be considered in light of the particular facts of each case"); In re S I Acquisition, 58 B.R. 454, 462 (Bankr. W.D. Tex. 1986) (endorsing application of broad equitable principles that would justify common representation of multi−affiliated entities), rev'd on other grounds , 817 F.2d 1142 (5th Cir. 1987); Chamberlin Corp ., 53 B.R. at 767 (allowing counsel to simultaneously represent DIP and interested party to avoid duplication of services and waste of assets, and reasoning that adverse interests should be allowed where likelihood of actual, material conflict is slight or nonexistent); In re Guy Apple Masonry Contractor Inc., 45 B.R. 160, 166 (Bankr. D. Ariz. 1984) (finding conflicts of interest "voidable as the facts may warrant").]

In *In re Global Marine Inc.*, [*FN:* 108 B.R. 998 (Bankr. S.D. Tex. 1987).] the bankruptcy court was faced with a challenge to counsel's fees based on the alleged conflict in counsel representing both the parent holding company and its subsidiary in consolidated chapter 11 cases. [*FN:* See id. at 998.] A creditor had objected to the affiliate debtors' counsel's fees on the basis of an inherent conflict since one of the subsidiaries was owed approximately $170 million by the parent holding company. [*FN:* See Global Marine , 108 B.R. at 1000−01. Global Marine and its subsidiaries owed one another approximately $1 billion in intercompany debt, including $170 million owed by Global Marine Deepwater Drilling to Global Marine. See id . at 1001. MCCC Corp. and the Bank of New York, the two principal creditors of Global Marine, requested counsel's fees be denied because their dual representation of Global Marine and Global Marine Deepwater Drilling constituted an impermissible conflict of interest under Code section 327(a). See id. at 1000.] After an exhaustive review of other cases involving joint representation of related entities, the court found that

the dual representation of the parent and subsidiary company did not result in an actual conflict of interest. [*FN:* See id. at 998. The Global Marine court found that dual representation of related entities with potential claims against each other was not, in and of itself, an actual conflict of interest. See id . at 1002. The court went reasoned that while a potential conflict of interest might indeed exist, that alone is not enough to justify disqualification. See Global Marine , 108 B.R. at 1002. The court cited three reasons why such preemptive action is not appropriate: (i) the potential conflict had not yet become actual, (ii) the parties always had and continued to pursue a unity of interest, and (iii) preemptive action would only serve to interrupt the orderly administration of the debtors' bankruptcy proceedings and cause them to incur unnecessary expense. See id. at 1004. For these reasons, the Global Marine court would have only actual conflicts result in denial or reduction of fees. See id.]

The cases on actual versus potential conflict diverge not so much in the distinction between potential and actual, but in the interpretation of when a conflict becomes sufficiently material so as to warrant disqualification. One view results in per se condemnation of all representation of affiliated parties from the time such representation begins, because it views all such arrangements as potentially compromising counsel's representation. [*FN:* Several courts have applied a presumption against potential conflicts. See*In re* Roger J. Au & Son Inc., 65 B.R. 322, 335 (Bankr. N.D. Ohio). The Roger J. Au court determined that past representation of the debtor corporation's sole shareholder and principal officer rendered counsel and his firm not disinterested and disqualified them. See id. at 336. Applying Canon 9 of the Model Code of Professional Responsibility, the bankruptcy court reasoned that even the mere appearance of impropriety in simultaneous representation provided the requisite lack of disinterestedness for the purpose of disqualification. See id. at 335. Some courts have gone further, decrying all conflicts as actual. See*In re* Kendavis Indus. Inc., 91 B.R. 742, 754 (Bankr. N.D. Tex. 1988). The Kendavis court described the concept of potential conflicts of interest as mistaken, holding that an actual conflict of interest arises the moment counsel "has any agreement, express or implied, with any management or a director of the debtor, or with a shareholder, or with any control party." *Id.*] The other view attempts to balance the dictates of section 327 and the perceived economies and practicalities of having one firm represent multiple affiliates. [*FN:* See*In re* BH & P Inc., 94 F.2d 1300, 1300 (3d Cir. 1991). The BH & P court considered the eligibility of a law firm to represent a debtor corporation and the corporation's two principals in three related chapter 7 liquidation proceedings. See id. at 1305. Applying a presumption against a potential conflict, the bankruptcy court disqualified both the trustee and counsel. See *In re* BH & P Inc., 103 B.R. 556, 564 (Bankr. D.N.J.), aff'd, 949 F.2d 1300 (3d Cir. 1991). On appeal, the 3rd Circuit adopted a "flexible approach" that, while presuming potential conflicts disqualifying, "allows the bankruptcy court to evaluate each case on its facts." See BH & P , 94 F.2d at 1315.]

As one court described the terms "actual" and "potential" as merely "different stages in the same relationship." [*FN:* BH & P , 103 B.R. at 563.] While an actual conflict can be defined as "an active competition between two interests in which one interest can only be served at the expense of the other," a potential conflict is "one in which the competition is presently dormant, but may become active if certain contingencies occur." [*FN:* See id.]

C. Selected Problems

1.111 May the Same Attorney or Law Firm Represent Multiple Creditors in a Bankruptcy Case?

The Model Rules of Professional Conduct and the case law, [*FN:* See Model Rules of Professional Conduct Rule 1.7 (1983).] not the Bankruptcy Code, governs representation of multiple creditors. [*FN:* See *In re* Star Broad. Inc., 81 B.R. 835, 837−39 (Bankr. D.N.J. 1988) (stating courts rely on § 327(a) standards, case law interpreting that section, and rules of professional conduct to determine whether a conflict of interest exists) (citing *In re* Philadelphia Athletic Club Inc., 20 B.R. 328, 335−36 (E.D. Pa. 1982); *In re* Roberts, 46 B.R. 815, 837−38 (Bankr. D. Utah 1985), aff'd in part, rev'd and vacated in part on other grounds, 75 B.R. 402 (D. Utah 1987); *In re* Chou−Chen Chems. Inc., 31 B.R. 842, 849−52 (Bankr. W.D. Ky. 1983)).] With the exception of the Rule 2019 [*FN:* Fed. R. Bankr. P. 2019 (detailing requirements for representation of creditors or equity security holders in chapters 9 and 11) .] requirements regarding disclosure of multiple representations, the professional conduct rules rather than the Bankruptcy Code regulate the representation of multiple creditors. There is no inherent ethical conflict in a lawyer representing more than one creditor in a bankruptcy case, so long as the dual representation is disclosed, clients are informed about possible implications of the dual representation, and each client consents. [*FN:* See Model Rules of Professional Conduct Rule 1.7; Cal. Rules of Professional Conduct 3−310(c) (providing for dual representation with informed written consent of the clients).] Consultation contemplates explaining to each client the implications, risks, and possible adverse consequences of the common representation. [*FN:* "Consultation" is defined in the Model Rules as "communication of information reasonably sufficient to permit the client to appreciate the significance of the matter in question." See Model Rules of Professional Conduct Terminology (1983); see also Griva v. Davison, 637 A.2d 830, 845 (D.C. Ct. App. 1994) (stating "[w]here dual representation creates a potential conflict of interest, the burden is on the attorney involved in the dual representation to approach both clients with an affirmative disclosure so that each can evaluate the potential conflict and decide whether or not to consent to continued dual employment").] All the clients must consent. [*FN:* See Model Rules of Professional Conduct Rule 1.7 cmt. [5] (1983) (stating when more than one client is involved, question of conflict must be resolved as to each client).] An attorney making the decision to represent more than one entity in connection with the bankruptcy case should carefully balance any risks to each client against the benefits and efficiencies of multiple representation. Only where the risks are minimal should dual representation be undertaken. Obviously, if the parties have potentially conflicting positions (such as one creditor being secured and the other unsecured) dual representation should not be undertaken. [*FN:* See id. Rule 1.16 (stating when conflict of interest arises during course of representation, lawyer must withdraw); see also id . Rule 1.7 cmt. [7].] Additionally, even if an attorney is representing two unsecured creditors, care should be taken to determine in advance whether one creditor may be forced to

defend a preference or other avoidable transfer which would result in potential direct adversity between the two clients.

The attorney should specifically inform each client of the circumstances under which counsel will be required to explain the reasons for a termination of representation. [*FN:* See id. Rule 1.6.] For example, communication from each client is privileged and confidential as to that client and could not be disclosed to the other in the context of explaining the reasons for withdrawal. [*FN:* See id. Rule 1.7 cmt. [5] (noting there may be circumstances where impossible to make disclosure necessary to obtain consent).] Obviously, an advance agreement with both clients is essential when an attorney is handling matters in which the two clients' interests may diverge. This agreement should specify that circumstances may occur which require counsel to withdraw without further explanation.

Bankruptcy Rule 2019 requires that any attorney who represents more than one creditor or equity security holder in connection with a bankruptcy case file a verified statement identifying each client and the nature of their claims or interests, together with certain facts relating to the circumstances of counsel's employment. [*FN:* Fed. R. Bankr. P. 2019(a).] If the circumstances of representation subsequently change, those facts must also be disclosed. [*FN:* See id.]

Failure to comply with Rule 2019 can be detrimental to the interests of clients since it may become the basis for disabling counsel from being heard at hearings. [See id.] Although it is not the primary responsibility of the bankruptcy court to police lawyer's ethical conduct, the Rule 2019 provision does afford the court and parties in interest information regarding certain multiple representations and has been used by at least one court as a vehicle to ensure attorneys' adherence to their ethical responsibilities. [*FN:* See LaFayette v. Oklahoma P.A.C. First Ltd. Partnership (*In re* Oklahoma P.A.C. First Ltd. Partnership), 122 B.R. 387, 393 (Bankr. D. Ariz. 1990).] In *LaFayette v. Oklahoma P.A.C. First Ltd. Partnership (In re Oklahoma P.A.C. First Ltd. Partnership),* [*FN:* 122 B.R. 387 (Bankr. D. Ariz. 1990).] a law firm proposed to represent a creditor who held the second lien on property while simultaneously representing the creditor with the first lien on the same property. [*FN:* See id. at 392.] The court intervened and refused to permit the law firm to represent both senior and junior lienholders since the court found that zealous representation of both was impossible. [*FN:* See id.] The court concluded that a corollary to the disclosure requirements of Rule 2019 was a corresponding obligation for the court to insist that lawyers adhere to ethical standards. [*FN:* See id . at 393.] Since dual representation of a junior and senior lienholder was an impermissible conflict for the law firm, at the suggestion of the court, the firm withdrew from further representation of either creditor in the case. [See LaFayette v. Oklahoma P.A.C. First Ltd. Partnership (*In re* Oklahoma P.A.C. First Ltd. Partnership), 122 B.R. 387, 392 (Bankr. D. Ariz. 1990).]

2.22 Representing a Creditor and a Creditors' Committee

In 1984, Bankruptcy Code section 1103(b) [11 U.S.C. § 1103(b) (1994).] was amended to provide that representation of one or more creditors of the same class shall not per se constitute the representation of an adverse interest when determining whether an attorney to be employed by a creditors' committee has a conflict. [*FN:* See id., as amended by Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98−353 § 500, 98 Stat. 333, 384; see also *In re* Rusty Jones Inc. , 107 B.R. 161, 162 (Bankr. N.D. Ill. 1989); *In re* Whitman, 101 B.R. 37, 38 (Bankr. N.D. Ind. 1989).] Although not a per se conflict, an attorney cannot represent creditors of different classes. [*FN:* See 11 U.S.C. §1103(b); see also Whitman , 101 B.R. at 39.] In *In re Whitman,* [*FN:* 101 B.R. 37 (Bankr. N.D. Ind. 1989).] a secured creditor with a large deficiency claim was a member of the unsecured creditors committee. [*FN:* See id. at 37.] The committee hired the undersecured creditor's attorney to represent the committee. [*FN:* See id.] On reconsideration, the court ordered that counsel either withdraw as counsel to the committee or as counsel to the undersecured creditor. [*FN:* See id. at 39.] The court found that while the undersecured creditor's interest as an unsecured creditor may be co−extensive with other unsecured creditors, such mutuality did not eliminate the irreconcilable conflict between secured and unsecured creditors. [See id.]

Often an unsecured creditors' committee will be comprised of unsecured creditors who may have different levels of priority among themselves pursuant to contractual subordination agreements. How does this "conflict" on the committee affect who the committee may retain? Courts have held that in such a situation, counsel will not be allowed to represent both the committee and the individual undersecured creditors. [*FN:* See *In re* Electro−Optix, U.S.A. Inc., 130 B.R. 621, 623 (Bankr. S.D. Fla. 1991) (disqualifying committee counsel for continuing to represent unsecured creditor); *In re* Oliver's Stores Inc., 79 B.R. 588, 595 (Bankr. D.N.J. 1987) (counsel seeking to represent committee while also representing individual creditor in suit against debtor's former accounting firm was denied permission for dual representation for fear that if accounting firm sought indemnification from DIP or officers, result could deplete assets otherwise available to creditors represented by committee); In re Grant Broad. Inc., 71 B.R. 655, 663 (Bankr. E.D. Pa. 1987) (holding counsel could not represent unsecured creditors committee and individual unsecured creditors attempting to force debtor to assume contract and pay administrative expense claim).]

3.33 Can a Lawyer Ethically Represent Both the Debtor in Possession (or a Trustee) and a Creditor in Connection with the Case?

An answer to this question requires a simultaneous analysis of Code section 327(c) [*FN:* 11 U.S.C. § 327(c) (1994).] as well as Model Rule 1.7(b). [*FN:* Model Rules of Professional Conduct Rule 1.7(b) (1983).] Prior to 1984, the Code contained an absolute prohibition against counsel simultaneously representing the trustee or debtor in possession (DIP), and a creditor in connection with the case. [*FN:* See *In re* AOV Indus. Inc., 797 F.2d 1004, 1011 (D.C. Cir. 1986) (prohibiting simultaneous representation of creditor and debtor) (citing *In re* Georgetown of Kettering, Ltd., 750 F.2d 536, 540 & n.7 (6th Cir. 1984)).] Apparently, that option is now open in the absence of an actual conflict. [*FN:* See *In re* Interwest Bus. Equip. Inc., 23 F.3d 311, 316 (10th Cir. 1994) (noting § 327(c), as worded, is intended to allow joint representation of trustee and creditor of estate if no apparent conflict of interest).] Code section 327(c) [*FN:* 11 U.S.C. § 327(c).] has been amended to prevent automatic disqualification due to dual representation, provided that if a party objects, the court must determine whether an actual conflict exists. [*FN:* See id.] Obviously, in most instances where an objection is made, an actual conflict would exist. Circumstances sometimes arise, however, where an attorney's firm has been asked to file a proof of claim, to handle a lease rejection dispute or some other matter in connection with the case, but thereafter, that same counsel is asked to replace debtor's counsel. Prior to 1984, that situation was impermissible. [*FN:* See 11 U.S.C. § 327(c), as amended by 11 U.S.C. §327(c) (1994).] Now, under section 327(c), the court would have to make a determination whether the representation of the creditor creates an actual conflict of interest with the representation of the debtor. [See id.]

Dual representation is regulated not only by section 327(c), but also by the professional conduct rules. Model Rule 1.7 provides that a lawyer shall not represent a client if that representation would be adverse to the interests of another client, unless each client consents after consultation and the lawyer makes an independent reasonable inquiry and conclusion that the representation will not adversely affect the interests of either client. [See Cal. Rules of Professional Conduct 3−310(C) (1996) (containing similar requirements requiring informed written consent from clients).]

The simultaneous representation of a debtor and a creditor, even if permissible under section 327(c), would seem to place the lawyer in a very precarious position given the application of Model Rule 1.7. Under that rule, if at any time a controversy were to arise and one of the two clients were to withdraw their consent to the dual representation, the lawyer would be required to withdraw from representation of either side. [*FN:* See Model Rules of Professional Conduct Rule 1.7 cmt. 2 (1983).] However, even if counsel withdraws from representation of one party, the court may still disqualify the attorney. [*FN:* See, *e.g.* ,*In re* Philadelphia Athletic Club Inc., 20 B.R. 328, 338 (Bankr. E.D. Pa. 1982) (disqualifying all members of law firm even though firm previously resigned as counsel for creditor). Cf. *In re* Smith, 79 B.R. 297, 299 (Bankr. S.D. Ohio 1987) (prohibiting dual employment by trustee and creditor even though attorneys did not seek any compensation for representation of trustee).] Given the potential that the lawyer would have to withdraw from the representation because of a creditor's change of heart, it would be ill advised and contrary to the best interests of a debtor−client to continue permit a lawyer to represent a creditor, even though no conflict exists at the time and all parties indicate a willingness to waive the conflict. Notwithstanding section 327(c), generally courts have been unwilling to permit dual representation. [*FN:* See *In re* BH & P Inc., 949 F.2d 1300, 1313 (3d Cir. 1991) (stating potential for conflict may, without more, justify disqualification);*In re* Glenn Elec. Sales Corp., 99 B.R. 596, 602 (D.N.J. 1988) (holding even without actual prejudice, sufficient risk of such justifies disqualification);*In re* Greater Pottstown Community Church, 80 B.R. 706, 711 (Bankr. E.D. Pa. 1987) (holding dual representations always result in disqualifying conflict. See generally William I. Kohn and Michael P. Shuster, Deciphering Conflicts of Interest in Bankruptcy Representation , 98 Com. L.J . 127, 143−44 (1993) (noting that some courts hold that potential conflict is enough to disqualify).] The courts' justifiable concerns relate to the prospect that the dual representation would lead counsel to fail to investigate preferences, conveyances and transactions between the creditor and the debtor. [*FN:* See, *e.g.* , Humble Place Joint Venture v. Fory (In re Humble Place Joint Venture), 936 F.2d 814, 819 (5th Cir. 1991) (noting counsel's loyalty to debtor's estate would be tested by counsel's other interests); In re Westwood Homes Inc., 157 B.R. 182, 184 (Bankr. D. Me. 1993) (finding attorney representing both corporate debtor and principal shareholder was conflict of interest sufficient to justify denial of compensation); In re Amdura Corp., 121 B.R. 862, 871 (Bankr. D. Colo. 1990) (noting firm's dual representation hindered ability to properly act as counsel).]

4. Simultaneous Representation of the Debtor and a Creditor in an

Unrelated Case

There is nothing in the professional conduct rules which ethically prohibit an attorney from representing two clients who have claims or litigation against each other, so long as the attorney (i) does not represent opposing parties in the same or substantially related litigation, or (ii) so long as the attorney's representation of one client in one matter does not materially and adversely affect his or her representation of the other client in other matters. [*FN:* See Model Rules of Professional Conduct Rule 1.7 (1983).] With informed consent, clients may waive most conflicts attendant to dual representation, except that a lawyer obviously may not represent opposing parties in the same litigation. [*FN:* See id.]

Dual representation, even in unrelated matters, becomes considerably more complex in bankruptcy cases. The strict section 327 requirements of disinterestedness and absence of an adverse interest overlay, if they do not in fact supplant, the professional conduct rules. [*FN:* See, *e.g.* , In re Kendavis Indus. Int'l Inc., 91 B.R. 742, 751 (Bankr. N.D. Tex. 1988) (stating "the Bankruptcy Code provisions dealing with conflicts of interest find their counterparts in the ABA Code of Professional Responsibility") (citing*In re* Maine Power & Equip. Co., 67 B.R. 643, 654 (Bankr. W.D. Wash. 1986)); In re Roberts, 46 B.R. 815, 830−31 (Bankr. D. Utah 1985), aff'd in part and rev'd and vacated on other grounds , 75 B.R. 402 (D. Utah 1987).] What may be ethically acceptable in commercial settings (*e.g.*, waivers upon informed consent) will not necessarily pass muster under section 327. This issue was highlighted in *In re Amdura Corp.* [*FN:* 121 B.R. 862 (Bankr. D. Colo. 1990).]

In *Amdura*, counsel represented both the corporate parent as well as two of its subsidiaries. [*FN:* See id. at 864.] The law firm for the three affiliated companies also represented a major creditor in the case on matters unrelated to the bankruptcies, and had not been involved on behalf of the creditor in connection with any loans to any of the debtors. [*FN:* See id.] Judge Matheson noted the Bankruptcy Code contemplates that counsel to the debtor in possession will be sufficiently free of divided loyalties as to be able to exercise a high degree of impartiality and detached judgment so it may single−mindedly pursue the interests of the debtor. [*FN:* See id. at 865.] The court also recognized, however, that the Bankruptcy Code itself creates a virtually irreconcilable conflict between the representation of no conflicting interest and the reality of the representation. [*FN:* See id.] The Bankruptcy Code clearly contemplates that the debtor can negotiate with creditor groups to reduce or reallocate amounts flowing to creditor classes in order to effect a plan. [*FN:* See 11 U.S.C. § 1129(a)(9) (1994) (noting one requirement for distributions to claimholders under reorganization plan provides that, "[e]xcept to the extent that the holder of a particular claim has agreed to a different treatment of such claim").] In doing so the debtor may even seek to preserve values to equity security holders which the "fair and equitable rule" would otherwise deny. [*FN:* See Amdura , 121 B.R. at 865 (establishing "fair and equitable" rule citing 11 U.S.C. § 1129(b)) .] This posture for counsel to the debtor in possession inherently places counsel in the position of representing conflicting interests. [*FN:* See id. at 865.] It is substantially impossible to fully and fairly represent as counsel to the debtor in possession the interests of the estate, creditors, and the equity owners. [*FN:* See id.] An inherent conflict would be inevitable in attempting to fulfill the duties of a trustee, as well as the duties of a chapter 11 debtor in possession. [*FN:* See id.] While this is not ethically unacceptable, it does seem to require the debtor in possession and its counsel to confront the nature of the tension and to be fair and open about which side of the line it is coming down on. [*FN:* See id.]

The *Amdura* court also addressed the question of the applicability of professional conduct rules. [*FN:* See*In re* Amdura Corp., 121 B.R. 862, 866 (Bankr. D. Colo. 1990).] The court noted that while those standards are applicable and must be considered by the court, activities and multiple representation that might be acceptable in commercial settings, particularly with the informed consent of clients, may not be acceptable in a bankruptcy case. [See id.] The court pointed out that section 327 of the Bankruptcy Code does not permit excusing the limitation of those provisions by waiver or by the trustee's consent to the representation of dual interests. [*FN:* See id. at 865.] To the contrary, the attorney must be disinterested and must not hold or represent an interest adverse to the estate. [*FN:* See id.] The explicit limitations contained in the statute reflect congressional concerns with perceived past abuses. [*FN:* See id.] They also recognize that what may be acceptable in a commercial setting, where all of the entities are solvent and creditors are being paid, is not acceptable when one or more of those parties is insolvent, and concerns exist about intercompany transfers and the preferences of one entity and its creditors at the expense of another. [*FN:* See Amdura , 121 B.R. at 865.] Finally, the question of the application of section 327 of the Bankruptcy Code is one of fact. [*FN:* See id.] Judge Matheson was unwilling to set down bright line tests in this area. [*FN:* See id. at 866.] Instead, the judge turned to a careful analysis of the facts and circumstances relating to the relationship between the multiple affiliates and the relationship of the law firm with regard to its prior representation of the major creditor. [See id. at 862.]

In *Amdura*, the law firm acknowledged that the major creditor was the "hand that fed" the firm. [See id. at 866.] Judge Matheson found it impossible for a law firm with such a pervasive financial relationship with one of the creditors in the case to meet the disinterestedness requirement of section 327. [*FN:* See Amdura , 121 B.R. at 866.] Using a factual analysis, the court distinguished between an isolated representation of a creditor in a totally unrelated matter versus a substantial reliance by the law firm on that creditor's business in unrelated matters. [*FN:* See id. at 871.]

The crucial factor for the court was the law firm's unwillingness to represent the debtor in connection with possible litigation against the creditor, proposing instead that an examiner be appointed and special counsel be retained to handle controversies with that creditor. [*FN:* See id. at 867.] The court found it unworkable and inappropriate for the law firm to attempt to "Chinese wall" itself from controversies with the major creditor when the negotiation of a plan of reorganization and decisions regarding the outcome of the case would turn in significant measure upon the extent to which that creditor's claims might be subject to attack. [*FN:* See id at 869.]

In *In re Occidental Financial Group Inc.,* [*FN:* Law Offices of Ivan W. Halperin v. Occidental Fin. Group (In re Occidental Fin. Group), 40 F.3d 1059, 1062 (9th Cir. 1994).] the court upheld the disqualification and disgorgement order against an attorney where the attorney represented affiliated debtors in simultaneous chapter 11 proceedings. [*FN:* See id.] The attorney also simultaneously represented the insiders of these debtors, their officers, directors and general partners. [*FN:* See id. at 1061.] The fact that the multiple representation was not disclosed when the cases were filed made the disqualification and disgorgement relatively easy for the court to impose. [*FN:* See id. at 1062.]

Likewise, the 10th Circuit affirmed a bankruptcy court's sua sponte disqualification of debtor's counsel where three chapter 11 debtors were controlled by one person and had intercompany claims. [See Interwest Bus. Equip. Inc. v. United States Trustee (In re Interwest Bus. Equip. Inc.), 23 F.3d 311, 318−19 (10th Cir. 1994).] However, the 10th Circuit stopped short of a per se disqualification rule when one attorney represents multiple debtors in possession. [*FN:* See id.]

In another case, a bankruptcy court denied all compensation to an attorney who received his retainer from the two largest unsecured creditors. [*FN:* See In re Crimson Invs., N.V., 109 B.R. 397, 402 (Bankr. D. Ariz. 1989). In a recent case, plaintiff sued the firm that had represented him in a suit against his former employer, a larger firm, on grounds of breach of fiduciary duty, amoung other things. The Southern District of New York denied defendant's summary judgment motion as to alleged breach of fiduciary duty based on potential ethical violations where the larger firm referred about a dozen cases to the smaller defendant firm. Re v. Kornstein Veisz & Wexler (*In re* Re), 1997 WL 162918 (S.D.N.Y.). The court reasoned that even though these cases accounted for approximately 2% to 3% of defendant firm's business, the amount of money made through the referrals was large enough to pose potential violations. *Id.* at *2, *20. The court cited concerns based on N.Y. D.R. 5−101(A). *Id.* at *19. In effect, failing to reveal to client that the employer he wished to sue had referred some cases to this firm, was enough to defeat a summary judgment motion!]

5.5 May Debtor's Counsel be Paid by a Nondebtor Third Party?

The professional conduct rules permit a lawyer to receive payment for professional services from a person other than his client so long as the consent of the client is obtained, client confidentiality is protected, the payment will not impair the lawyer's independent professional judgment to act on behalf of the client (not the payor), and the lawyer−client relationship is not invaded by the third party payor. [*FN:* See Model Rules of Professional Conduct Rule 1.8(f) (1983) (outlining conflict of interest and prohibited transactions). The Model Rules allow for third party payor situations when certain circumstances exist. Rule 1.8 provides in relevant part: A lawyer shall not accept compensation for representing a client from one other than the client unless: (1) the client consents after consultation; (2) there is no interference with the lawyer's independence of professional judgment or with the client−lawyer relationship; and (3) information relating to representation of a client is protected as required by Rule 1.6 [confidentiality of information]. *Id.*]

From time to time, an entity needing the benefit of bankruptcy relief will not have sufficient resources to pay counsel a retainer because its assets are fully encumbered. Third parties−−perhaps lenders, guarantors, or shareholders−−may have an incentive to advance funds to debtor's counsel when the debtor is unable to do so.

Courts are divided with respect to whether fee payments from sources other than the debtor are permitted under the Bankruptcy Code. [*FN:* See infra notes 238−241 and accompanying text.] Several courts have concluded that such payments are prohibited because the payments create a per se conflict of interest. [*FN:* See In re Hathaway Ranch Partnership, 116 B.R. 208, 219 (Bankr. C.D. Cal. 1990); In re WPMK Inc., 42 B.R. 157, 163 (Bankr. D. Haw. 1984).] The Supreme Court has held some third party payments prohibited because the attorney should not place himself in a position where he may be required to choose between conflicting duties. [*FN:* See Woods v. City Nat'l Bank & Trust Co., 312 U.S. 262, 268 (1941); see also *In re* Senior G & A Operating Co., 97 B.R. 307, 310 (Bankr. W.D. La. 1989); In re 765 Assocs., 14 B.R. 449, 451 (Bankr. D. Haw. 1981); In re Bergdog Prods. Inc., 7 B.R. 890, 892 (Bankr. D. Haw. 1980). But see *In re* Glenn Elec. Sales Corp., 89 B.R. 410, 416 (Bankr. D.N.J. 1988) (loaning money to principal of debtor does not equal representation of creditor), aff'd , 99 B.R. 596 (D.N.J. 1988).]

Some cases have taken a less rigid approach to the problem of third party payment of counsel fees. [*FN:* See David & Hagner, P.C. v. DHP Inc., 171 B.R. 429, 437 (D.D.C. 1994) (rejecting requirement if applying to bankruptcy court for third party guarantee and allowing payment of fees), aff'd , 70 F.3d 637 (D.C. Cir. 1995); see also *In re* Lotus Prop. L.P., 200 B.R. 388, 394 (Bankr. C.D. Cal. 1996) (accepting less rigid approach to third party payment over per se rule actual conflict rule); *In re* Kelton Motors Inc., 109 B.R. 641, 658 (Bankr. D. Vt. 1989) (establishing five−part test to retain counsel paid by debtor's insiders).] These cases reason that counsel should not be automatically disqualified by virtue of a third party payment, but that such payment should disqualify counsel only if it puts him or her in a position of actually representing an interest adverse to the estate. [*FN:* See *In re* Missouri Mining Inc., 186 B.R. 946, 949 (Bankr. W.D. Mo. 1995) (rejecting per se rule that third party payment is actual conflict and looks to fact−specific determination of whether counsel holds interest adverse to estate). The Missouri Mining court identified four factors to determine if third party payment is basis for disqualification: (1)whether there was any specific advantage to the third party; (2) whether there was any injury to the estate; (3) whether there was prejudice to other creditors; and (4) whether an actual conflict arising from the payment is apparent. See id . (citing *In re* Olson, 36 B.R. 74, 76 (D. Neb. 1983); see also Lotus , 200 B.R. at 394 (following "analytical approach" to payment of fees by third party); Kelton , 109 B.R. at 642 (rejecting per se rule since it deprives future small corporate debtors from obtaining counsel of choice).] In determining whether an adverse interest exists, the definition developed in *In re Roberts* [*FN:* 46 B.R. 815, 826 − 27 (Bankr. D. Utah 1985), aff'd in part, rev'd and vacated on other grounds , 75 B.R. 402 (D. Utah 1987).] is instructive:

An adverse interest is the possession or assertion of any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant or to possess a predisposition under circumstances that render such a bias against the estate. [*FN:* See id. at 827.]

On its face, merely receiving money from a third party in connection with the debtor's bankruptcy case should not constitute an interest adverse to the estate or taint the disinterestedness of counsel. The fact that a payment is made by a creditor of the debtor does not automatically equal representation of that creditor's interest. [*FN:* See *In re* Glenn Elec. Sales Corp., 89 B.R. 410, 416 (Bankr. D.N.J. 1988) (loaning money to principal of debtor does not equal representation of creditor), aff'd , 99 B.R. 596 (D.N.J. 1988).] Moreover, payment of fees by a sole shareholder does not equate to representation of the shareholder. [*FN:* See Glenn Elec ., 99 B.R. at 597 (holding payment by 100% shareholder does not equal representation of that shareholder).] Indeed, payment to a lawyer by one person to represent a different person is not uncommon. Insurance carriers, prepaid legal plans, employers and parents are examples of frequent third−party payors. It is unrealistic to conclude that the interests of the debtor corporation and its sole shareholder always conflict. In many instances the interests of a corporate entity and its sole shareholders do not run divergent or even parallel courses, but rather the interests go hand in hand. [*FN:* See Glenn Elec. , 89 B.R. at 416.] Third−party payment should not, in and of itself, result in automatic disqualification.

Counsel not only must avoid representing an interest adverse to the estate, but must also be a disinterested person under section 327(a). [*FN:* See 11 U.S.C. § 327(a) (1994) (dealing with employment of professionals); see also *In re* Star Broad. Inc., 81 B.R. 835, 838 (Bankr. D.N.J.) (stating two−prong test to qualify counsel includes disinterestedness); *In re* O'Connor, 52 B.R. 892, 895 (Bankr. W.D. Okla. 1985) (requiring disinterestedness of professional person).] Disinterestedness, defined in section 101(14)(E), [*FN:* See 11 U.S.C. § 101(14)(E).] includes a "catch all" (not having an interest materially adverse to the interest of the estate by reason of any direct or indirect relationship to, connection with or interest in the debtor). [*FN:* See id..] An expansive definition of disinterestedness under section 101(14)(E) would probably result in disqualification of counsel who received any third−party payment. Since the payment came from a party who is not disinterested, the payee law firm cannot be disinterested.

In *In re* Glenn Electric Sales Corp., [*FN:* 89 B.R. 410 (Bankr. D.N.J.), aff'd , 99 B.R. 596 (D.N.J. 1988).] the court reasoned that an analysis of disinterestedness should consider the facts and circumstances relating to the relationship between the payor, the debtor, and the bankruptcy process. [*FN:* See id. at 417.] The third party payor in this case announced that it was a likely plan proponent. [*FN:* See id. at 412.] The court found receipt by debtor's counsel of fees from a prospective plan proponent sufficient to result in a lack of disinterestedness and hence, justified disqualification of the law firm. [*FN:* See id. at 418.] The court observed that in addition to those who are already in the picture with competing interests−−creditor, debtor, and third party proponent, equity security holders, and those with administration claims−−"[a]ll one needs to do is add an additional ingredient, namely counsel for the debtor who has been paid by the principal of the debtor with monies advanced by the plan proponent and the potential plight of unsecured creditors is obvious." [*FN:* See id . at 417.]

Even the mere appearance of impropriety can be grounds for disqualification. [*FN:* See Glenn Elec ., 89 B.R. at 417.] The *Glenn Electric* court acknowledged that its disqualification of debtor's counsel was grounded more on the appearance of impropriety than on any actual conflict at the time of the hearing, but concluded that counsel should nevertheless be disqualified. [*FN:* See id. at 418.] Interestingly, the law firm that had been disqualified had not been candid with the court with respect to the disclosure of the source of its payment and the relationship of the paying party to the bankruptcy case. [*FN:* See id . at 415.] Therefore, this case can therefore also be read as a warning that counsel's lack of candor with the court, aside from any implications of the third party payment itself, might be a decisive factor in the court's decision to disqualify. [*FN:* See *In re* Arlan's Dep't Stores Inc., 615 F.2d 925, 928 (2d Cir. 1979) (denying substantial fees to two law firms that persistently failed to disclose fee arrangements between themselves that could have been adverse to client); *In re* Roberts, 75 B.R. 402, 413 (D. Utah 1987) (disallowing fees to law firm representing debtor corporation for failure to disclose conflicts of interest).]

The approach taken by the *Glenn Electric* court, [*FN:* See Glenn Elec ., 89 B.R. 410 (Bankr. D.N.J.), aff'd , 99 B.R. 596 (D.N.J. 1988).] coupled with scrupulous adherence by counsel to the disclosure requirements provided for in section 327, [*FN:* See 11 U.S.C. § 327 (1994).] Rule 2014, [*FN:* See Fed. R. Bankr. P. 2014.] and Model Rule 1.8(f) [*FN:* See Model Rules of Professional Conduct Rule 1.8(f) (1983).] should sufficiently police any problems arising from the payment of legal fees by a third party for a debtor. A per se rule resulting in disqualification of counsel merely because of receipt of funds from a third party seems overly rigid and would limit the access of many debtors to quality representation. This limitation would be particularly true where the debtor's assets are encumbered by substantial liens or the debtor has insufficient resources or liquidity to retain counsel for a perhaps unexpected bankruptcy. Furthermore, the Bankruptcy Code appears to clearly recognize that payment by third parties for the benefit of the debtor may be necessary. Section 329(b) [*FN:* See 11 U.S.C. § 329(b).] provides that the court may order the return of excessive fees either to the estate or to *the entity that made such payment*. [See id. (emphasis added).]

6.6 What is an Attorney's Duty to Police Debtor's "Improper" Conduct During a chapter 11 Case?

There is little authority regarding the obligation of debtor's counsel to police acts taken by the debtor or its management during bankruptcy proceedings. [*FN:* Importantly, however, bankruptcy Rule 9011 requires an attorney to make a "reasonable inquiry" to ensure that all documents served or filed in a bankruptcy case on behalf of his client are well−grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law." Fed. R. Bankr. P. 9011(a).] At a minimum, it seems logical that if the Bankruptcy Code empowers a chapter 11 debtor in possession to attempt to reorganize, certainly debtor's counsel and probably debtor's management should not incur personal liability (absent criminal or tortious conduct) if the reorganization effort fails. [*FN:* See, e.g., Scheftner v. Foster (*In re* Dieringer), 132 B.R. 34, 36 (Bankr. N.D. Cal. 1991) (holding attorney free from liability for gross mismanagement by debtor's management).]

It is not unusual for chapter 11 debtors to dissipate assets of an estate so a case that would have initially yielded a dividend to creditors if filed as a liquidation case, becomes a no asset case after the debtor's futile attempt to reorganize. [*FN:* See id.] Frequently, the estate will suffer operating losses, diminution in value of assets, and creation of postpetition debts with priority over prepetition creditors. [*FN:* See id.] Nonetheless, Congress has expressed its will that reorganization efforts be encouraged. [*FN:* See S. Rep. No . 95−989, at 94 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5880; H.R . Rep. No. 95−595, at 380 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6336.] Section 706(a) of the Bankruptcy Code reflects this intent by giving the debtor an unconditional right to convert a liquidation case to a reorganization case. [*FN:* See 11 U.S.C. § 706(a) (1994).] Moreover, the entire concept of reorganization contemplates a certain degree of entrepreneurship by a debtor's management in attempting to extend the value of the company as far as possible down the hierarchy of parties in interest (secured creditors, lessors, unsecured creditors and ultimately equity security holders). [*FN:* See id. § 1129(b).]

Debtor's counsel has a difficult enough burden without being a policeman for the debtor's postpetition conduct. [*FN:* See Scheftner v. Foster (*In re* Dieringer), 132 B.R. 34, 36 (Bankr. N.D. Cal. 1991) (stating "policy . . . that the debtor should always be given the opportunity to repay his debts").] Under the federal bankruptcy law, that role is left to creditors' committees, individual creditors, and the United States Trustee. [*FN:* See id.] Vehicles are available to organized constituencies and individual parties in interest (as well as the United States Trustee) in the form of the appointment of a trustee [*FN:* See 11 U.S.C. § 1104.] or conversion of the case, [*FN:* See id. § 1112.] such that counsel and management should be free to exercise a reasonable degree of flexibility with the estate's assets to achieve a successful reorganization. So long as the attorney is not actively engaged in illegal conduct, his or her zealous efforts on behalf of the debtor should not be chilled by the threat of a suit from creditors if the reorganization fails. [*FN:* See Dieringer , 132 B.R. at 36.] Although bad judgment by the debtor, the debtor paying itself too great a salary, or failure to pay postpetition obligations, may be grounds for conversion or the appointment of a trustee, they are not the sort of illegal conduct for which an attorney representing the debtor should be personally liable, or for which he or she should suffer financially in fee application hearings. [*FN:* See id.] However, courts have held that attorneys have a duty to inquire when warning flags appear regarding actions by the debtor or the debtor's principal and to resolve those concerns or face the possibility of losing fees. [*FN:* See In re Wilde Horse Enters. Inc., 136 B.R. 830, 840 (Bankr. C.D. Cal. 1991) (stating attorney is fiduciary to estate and has duty to remind debtor of duties under Code); Cf.*In re* Consupak Inc., 87 B.R. 529, 548−49 (Bankr. N.D. Ill. 1988) (stating that duty of trustee's attorney requires active concern for interests of estate and unsecured creditors, including taking initiative "to inform his client of the need for preventative or corrective action.")]

The imposition on debtor's counsel of a greater duty than that of a zealous advocate for the reorganization of the business would seem to create problems for counsel in adhering to the requirements of the professional conduct rules. Lawyers are not retained to provide business advice to clients. Model Rule 1.2 clearly provides that a lawyer shall abide by a client's decision concerning the objectives of the representation. [*FN:* See Model Rules of Professional Conduct Rule 1.2 cmt. 1 (1983) (stating client has ultimate authority of representation).] Model Rule 1.4(b) provides that the lawyer must explain to the client the alternatives available, but that the client ultimately decides the course of action to be taken. [*FN:* See id. Rule 1.4(b) (stating client must be provided with information to participate in decision−making process).]

The lawyer represents the organization which itself acts through its duly authorized constituents. [*FN:* See id. Rule 1.13.] Several courts have recognized that under applicable ethical rules, counsel for a debtor entity is directed by management. [*FN:* See *In re* Nephi Rubber Prods. Corp., 120 B.R. 477, 482 (Bankr. N.D. Ind. 1990) (stating officers and directors choose counsel and counsel obligated to follow directors); see also *In re* Hurst Lincoln Mercury Inc., 80 B.R. 894, 897 (Bankr. S.D. Ohio 1987) (stating counsel must look to operating head of DIP as client's voice).] Ethically and legally, counsel to the debtor in possession can only advise the debtor's designated representatives who make the decisions.

The debtor in possession and its management are not required by the Bankruptcy Code to be disinterested. [*FN:* See, e.g., *In re* Best W. Heritage Inn Partnership, 79 B.R. 736, 740 (Bankr. E.D. Tenn. 1987) (stating no reason for debtor in possession to be disinterested).] To the contrary, Congress contemplated that the competing interests of creditors could be protected by their own counsel, by creditors' committees and by the United States Trustee. [*FN:* See 11 U.S.C. § 1102(a)(1) (1994) (authorizing US Trustee to appoint creditors' committees).] Attorneys who take directions from interested insider management are not substitutes for the trustees, and Congress seemingly intended not to impose upon debtor's counsel, through the vehicle of disinterestedness, [*FN:* See id. § 327(a).] a duty to insure that insider management act as a trustee. For example, in *In re Best Western Heritage Inn Partnership*, [*FN:* 79 B.R. 736 (Bankr. E.D. Tenn. 1987).] the court observed that it is difficult to believe that Congress intended to require a disinterested attorney for the debtor in possession to safeguard the rights of creditors and investors. [*FN:* See id. at 740.] Vigorous advocacy by debtor's counsel is not only ethical; it is required.

How does counsel deal with the dilemma of the client who decides to undertake a "scorched earth" policy with respect to the bankruptcy case? Those of us who have represented debtors have all faced a client who said, "If this case cannot work for me and to my economic interest, then I will see to it that the creditors don't get anything." The dilemma faced by counsel is obvious. Under the Bankruptcy Code, counsel knows that there is a hierarchy of interests intended to be protected by the Bankruptcy Code and that the debtor in possession cannot abuse its control over the estate's assets to extort value for subsidiary interests at the risk of significant loss to senior interests. [*FN:* See 11 U.S.C. § 1129(b) (imposing "absolute priority" rule).] Moreover, it is reasonably clear that management in a chapter 11 case has a duty to operate in a way which will maximize recovery to creditors in accordance with the congressionally mandated hierarchy of interests. [*FN:* See United States v. Aldrich (*In re* Rigden), 795 F.2d 727, 730 (9th Cir. 1986) (stating chapter 11 trustee or debtor in possession has "fiduciary obligation to conserve the assets of the estate and to maximize distribution to creditors"); First Union Nat'l Bank v. Tenn−Fla Partners (*In re* Tenn−Fla Partners), 170 B.R. 946, 970 (Bankr. W.D. Tenn. 1994) (same); National Convenience Stores Inc., v. Shields, 106 B.R. 792, 797 (Bankr. S.D. Tex. 1993) (recognizing debtor in possession's management takes on heightened fiduciary duties of chapter 11 trustee).] When management adopts a "scorched earth" policy that conflicts with that duty, what is counsel to do? On one extreme, a flagrant "scorched earth" strategy by debtor's management would seem to cross the line of Rule 11 governing good faith standards with respect to positions taken in litigation. [*FN:* See Fed. R. Civ. P. 11.] What, however, of less flagrant circumstances where counsel, based on experience, knows that the business policies advocated by management constitute gambling with the estate's assets, or are otherwise significantly irresponsible? In these circumstances, rather than carrying out client directions which exceed the boundaries of what counsel believes are appropriate, the debtor in possession's attorney has an ethical obligation to counsel his client with respect to its fiduciary duties. [*FN:* See *In re* TS Indus. Inc., 125 B.R. 638, 642 (Bankr. D. Utah 1991); *In re* NRG Resources Inc., 64 B.R. 643, 647 (W.D. La. 1986).] But what additional responsibilities does the debtor's counsel have?

The professional conduct rules provide that the lawyer is a part of a judicial system charged with upholding the law. [See Model Rules of Professional Conduct Preamble 4 (1983) (providing "lawyer's duty to uphold legal process").] One of the lawyer's functions is to advise clients so that they avoid any violation of the law in the proper exercise of their rights. [*FN:* See id. Rule 1.2(d) (stating counsel may assist client to determine law).] In representing a client, the lawyer shall exercise independent professional judgment and render candid advice. [*FN:* See id. Rule 2.1.] Counsel to the debtor in possession has the obligation to refrain from taking frivolous positions. [*FN:* See id. Rule 3.1; Cal. Rules of Professional Conduct 3−200 (1996) (requiring attorney not to seek accept, or continue employment knowing that objective of employment is to bring action or assert position without probable cause and for purpose of harassing or maliciously injuring another person).] In addition, a lawyer shall make reasonable efforts to expedite litigation consistent with the interests of the client. [*FN:* See Model Rules of Professional Conduct Rule 3.2.] The comment to the rule, however, states plainly that realizing financial or other benefit from otherwise improper delay in litigation is not a legitimate interest of the client. [*FN:* See id. Rule 3.2 cmt.] Finally, when a lawyer knows that a client expects legal assistance not permitted by the professional conduct rules or other law, the lawyer shall consult with the client regarding the relevant limitations on the lawyer's conduct. [*FN:* See id . Rule 1.2(e).]

Assume that the lawyer discharges his responsibility to render candid advice and to properly counsel the client that the client's proposed "scorched earth" course of action goes beyond that permitted under the Bankruptcy Code. If the management of the debtor in possession again insists upon following such a course of action (which in counsel's view is a breach of management's fiduciary responsibilities), the lawyer should first go up the corporate chain of command, ultimately to the board of directors. [*FN:* See, *e.g.* , In re McNar Inc., 116 B.R. 746, 751−52 (Bankr. S.D. Cal. 1990).] If the client continues to insist that the action be taken, and counsel is certain that the action is *clearly* a violation of the law and is likely to result in substantial injury to the organization, the lawyer is authorized to withdraw. [*FN:* See Model Rules of Professional Conduct Rule 1.16(a), (b).] According to the 9th Circuit, a lawyer in this situation may even be required to resign. [*FN:* See Everett v. Perez (In re Perez), 30 F.3d 1209, 1219 (9th Cir. 1994) (stating lawyer "must seek to persuade his client to take a different course or, failing that, resign").]

Counsel should urge management to meet its fiduciary duties to creditors, but counsel should abide by the client's decision so long as there is a non−frivolous basis for doing so. [*FN:* See Model Rules of Professional Conduct Rule 1.2 (providing lawyer must abide by client's decision as long as decision ethically permissible).] If the attorney and client disagree, it is not the attorney's prerogative to act on his own as he believes best for the estate, but the attorney has a duty to refrain from filing bad faith or frivolous pleadings and to withdraw if the high standard for withdrawal is met. [*FN:* See id. Rule 1.16(a), (b).] If a creditor or United States Trustee object to the position taken by the debtor in possession's management, the remedy

is to seek to displace management, to convert the case, or to seek other relief from the court. [*FN:* See 11 U.S.C. § 1112(b) (1994) (authorizing court to convert or dismiss chapter 11 case for cause on request of party in interest or U.S. Trustee).]

Ultimately, the court has adequate means for ensuring debtor's counsel acts diligently to ensure that the debtor in possession's management protects the estate from dissipation in its complete control over attorney compensation pursuant to Code section 329. [*FN:* See 11 U.S.C. § 329.] This control should be adequate to ensure that attorneys do not knowingly assist debtors in abusing the bankruptcy laws. For example, one firm's fees were reduced by $250,000 for failing to advise the court that its debtor−client's investment advisor had obtained a conflict postpetition. [*FN:* See*In re* CF Holding Corp., 164 B.R. 799, 808 (Bankr. D. Conn. 1994).]

Practically, the court's supervision of professional fees paid by the debtor can often put counsel into a position which conflicts with his own client regarding operations in chapter 11. Management, not being required to be disinterested, [*FN:* See supra notes 286−87 and accompanying text.] may prefer to take significant risks with the estate's assets that creditors oppose. By subtle suggestion or otherwise, debtor in possession's counsel can permit or assist management in implementing a speculative strategy by seeking court approval or using various litigation tactics. If it turns out that the strategy fails and there is a diminution of estate assets, a suggestion will undoubtedly be made by disappointed or frustrated creditors that counsel had a duty to police the conduct of the debtor and to "blow the whistle" on management. As long as counsel for the debtor complies with its ethical obligations and as long as management's actions do not exceed the bounds of propriety necessitating a withdrawal, counsel should not be burdened with a concern that compensation otherwise earned could be diminished because of counsel's zealous advocacy of the debtor's position. [*FN:* See generally Best W. Heritage Inn Partnership, 79 B.R. 736, 740 (Bankr. E.D. Tenn. 1987) (supporting proposition that DIP's attorney cannot be reasonably expected to safeguard rights of all parties in interest).] Counsel should be aware of cases such as *In re Rivers*, [*FN:* 167 B.R. 288 (Bankr. N.D. Ga. 1994).] which stated that an attorney has the duty to advise the U.S. Trustee and the court if a debtor in possession is incompetent, making a reorganization unlikely. [*FN:* See id. at 300.] The court also stated that the attorney's duty to the court and duty as fiduciary to the bankruptcy estate deserves higher allegiance than the role as attorney for the debtor. [*FN:* See id . at 301 (holding that if interests of court or estate conflict with interests of debtor, then court and estate interests control).]

7.7 May the Same Firm Simultaneously Represent Unsecured Creditor Committees of Debtors Who are Economic Competitors?

Can a law firm serve as committee counsel to two separate committees for debtors that are direct economic competitors? What if the Debtors are direct economic competitors of similar size, servicing the same markets, and selling similar goods often within several miles of each other? What if the committees have overlapping membership? This unique situation was recently faced in *In re Caldor Inc.*, [*FN:* 193 B.R. 165 (Bankr. S.D.N.Y. 1996).] in which Caldor Inc. and its related entities ("Caldor") filed a bankruptcy petition after its competitor Bradlees Corp. and affiliated companies ("Bradlees") had already filed a bankruptcy petition. [*FN:* See id. at 169.] Originally four members of the Caldor Committee were selected to serve on the Bradlees Committee, which later dropped to three when one member resigned from the Caldor Committee. [*FN:* See id.]

The Caldor Committee and its proposed law firm made full disclosure to all parties of the proposed retention of the same law firm by both committees. [*FN:* See id.] The United States Trustee objected to the employment of the law firm by the Caldor Committee. [*FN:* See id.] The Trustee's objection was based on the contention that the law firm held an adverse interest in connection with the case pursuant to 11 U.S.C. section 1103(b) as applied by section 327(a) and therefore could not be employed by the committee. [*FN:* See Caldor , 193 B.R. at 170−171.] The Trustee contended that Caldor or Bradlees might merge,

be bought out by a national discounter, liquidate, or compete in the purchase of other troubled discounters. [*FN:* See id . at 171.]

In *Caldor*, Judge Garrity rejected the contention that simultaneous representation of the two creditors' committees for debtors that were economic competitors created a per se adverse interest in connection with the case. [See id.] The Court did agree with the stipulated evidence that Bradlees and Caldor were economic competitors and "in that sense, they are adverse to one another." [*FN:* See id .] However, the court rejected the trustee's contentions regarding possible mergers or liquidations of either debtor as a basis for holding an adverse interest because evidence of those possibilities was too speculative. [*FN:* See id. at 172−173 (stating that although possible to devise scenario of adverse interests, record does not support such imaginations).] Even though a hypothetical set of facts could be devised to create a conflict, "horrible imaginings alone cannot be allowed to carry the day." [*FN:* Caldor , 193 B.R. at 172 (quoting In re Martin, 817 F.2d 175, 183 (1st Cir. 1987)).]

The Bradlees Committee was not a creditor or competitor of the Caldor Committee and therefore representation of both committees did not create an adverse interest in connection with the case. [See id. at 171−72 (ruling committees do not hold disqualifying "adverse interests" because committees, like debtors are not likely to become rival claimants).] The Court looked to two alternative tests to determine whether representation of the Bradlees Committee created a disqualifying conflict: (i) First, it inquired whether the simultaneous representation "create[s] 'either a meaningful incentive to act contrary to the best interest of the [Caldor Committee]−−an incentive sufficient to place those parties at more than acceptable risk−−or the reasonable perception of one,' " [*FN:* Id . at 172 (quoting In re Martin, 817 F.2d at 175, 180 (1st Cir. 1987)).] or (ii) " 'if it is plausible that the representation of [the Bradlees Committee] will cause [the Professionals] to act any differently than they would without that . . . representation, then they have a conflict and an interest adverse to the [Caldor Committee].' " [*FN:* Id . at 171 (quoting In re Leslie Fay Cos. Inc., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994)).] The court found that neither situation existed and the law firm did not have an adverse interest in connection with the case because the committees were not competitors in any forum. [*FN:* See id .] The Court found that the law firm's implementation of an information barrier between the bankruptcy teams for Bradlees and Caldor augmented, rather than undermined, the propriety of the simultaneous representation. [*FN:* See Caldor , 193 B.R. at 182.]

8. Is it proper for a trustee to represent him or herself in connection

with the case?

Assuming a trustee and his law firm are disinterested and do not represent an interest adverse to the estate, Code section 327(d) authorizes a trustee to represent himself if it is in the best interest of the estate. [*FN:* See 11 U.S.C. § 327(d)

(1994).] The ethical problem faced by a trustee who seeks to retain himself or his law firm to act as counsel arises from the provision in Code section 328(b) which limits the trustee's compensation to purely legal matters, not trustee or management matters. [*FN:* See 11 U.S.C. § 328(b) (1994) .] A trustee who represents himself has a built−in conflict in most cases in that his economic self interest will tempt him to characterize his work as legal, not managerial. A number of courts addressing the issue have held that a trustee must show good cause to justify retaining himself as counsel. [*FN:* See, e.g., *In re* Butler Indus . Inc., 101 B.R. 194, 197 (Bankr. C.D. Cal. 1989), aff'd , 114 B.R. 695 (C.D. Cal. 1990).]

The *Butler* case identifies certain causes which would justify a trustee's retention of his firm. [*FN:* See id.] Among these are (I) the trustee's demonstration that his appointment, as opposed to that of a third party, would result in substantial savings to the estate; (ii) demonstration that much of the legal work must be undertaken immediately and there is no time to await the appointment of outside counsel; (iii) a showing that there is little work to perform which does not merit the retention and expense of an outside lawyer; and (iv) a showing that the estate's assets consist principally of causes of action, and legal counsel would have to look to the recovery in those actions for payment. [*FN:* See id.] Even assuming such grounds exist, the *Butler* court required notice to all creditors of a trustee's proposed retention of his own firm. [*FN:* See id. ; see also *In re* Gem & Serv. Co., 117 B.R. 874, 880 (Bankr. S.D. Tex. 1990).] Another court has consistently refused to authorize the employment absent a showing of cause. [*FN:* See In re Cee Jay Discount Stores Inc., 171 B.R. 173, 176 (Bankr. E.D.N.Y. 1994) (stating trustee should not employ own firm without showing strong reason);*In re* Showcase Jewelry Design, Ltd., 166 B.R. 205, 206 (Bankr. E.D.N.Y. 1994); see also Knapp v. Seligson (*In re* Ira Haupt & Co.), 361 F.2d 164, 168 (2d Cir. 1966) (noting trustee should be discouraged from retaining himself).]

III. Consequences of Ethical Violations

("What can they do to me?")

As noted throughout this article, it appears that in the majority of cases where violations occur, attorneys are economically penalized by courts refusing to approve fee applications for work done. [*FN:* See, e.g., See*In re* CF Holding Corp., 164 B.R. 799, 808 (Bankr. D. Conn. 1994) (reducing fee by substantial amount);*In re* McNar Inc., 116 B.R. 746, 752 (Bankr. S.D. Cal 1990) (depriving attorney of fees for violating disclosure requirements to debtor's board of directors); In re Crimson Invs., N.V., 109 B.R. 397, 400−01 (Bankr. D. Ariz. 1989) (denying all compensation to attorney who improperly received retainer from two largest unsecured creditors);*In re* Davison, 79 B.R. 859, 861 (Bankr. W.D. Mo. 1987) (finding counsel who aided and abetted dissipation of bankruptcy estate's funds and assets was properly denied any and all attorney's fees).]

A. Fines and Imprisonment

Some violations may be criminal and carry penalties of fines and possible imprisonment. Although such cases are thankfully uncommon, attorneys should nevertheless should be aware of these cases so as to avoid even being implicated. For instance, under title 18 section 156, non−lawyer bankruptcy petition preparers [*FN:* 18 U.S.C. § 156(a) (1994) defines a "bankruptcy petition preparer" as "a person, other than the debtor's attorney or an employee of such an attorney, who prepares for compensation a document for filing." *Id.*] are now subjected to federal criminal liability. [*FN:* See 18 U.S.C. § 156.] In fact, the FBI has begun investigating more bankruptcy crimes than at any other time in the past. The section was revised partly a result of the notoriety of the problem. The Bankruptcy Reform Act of 1994 not only revised and clarified the existing provisions of title 18 sections 152, 153, and 154, it added two new sections, section 156 and section 157. [See supra note 11. See 18 U.S.C. §§ 152, 153, and 154, as amended by Pub. L. No. 103−394, § 312, 108 Stat. 4107, 4138−40 (1994). See 18 U.S.C. §§ 156, 157, as amended by Pub. L. No. 103−394, § 312, 108 Stat. 4107, 4140 (1994).] Section 157 provides:

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

(1) files a petition under title 11;

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

(3) makes a false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under title 11, . . .

shall be fined under this title, imprisoned not more than 5 years, or both. [*FN:* See 18 U.S.C. § 157.]

While the primary emphasis is on non−lawyers, attorneys should be aware of sanctions they might be subjected to for authorizing the filing of a debtor's fraudulent petition. [*FN:* See, *e.g.* ,*In re* Hessinger & Assocs., 171 B.R. 366, 372 (Bankr. N.D. Cal. 1994) (sanctioning attorney for acting as figurehead for nonlawyers who charged legal fees); Geibank Indus. Bank v. Martin (*In re* Martin), 97 B.R. 1013, 1017 (Bankr. N.D. Ga. 1989) (sanctioning attorney for authorizing someone in his office to sign, prepare, and file debtor's petition).]

Under title 18 section 153, in addition to criminal charges, debtors and their attorneys should be forewarned that even if the bankruptcy case eventually ends in

discharge, debts created by improper, fraudulent acts nevertheless remain unaffected by the discharge. [*FN:* See 11 U.S.C. § 523 (1994).]

B. Conspiracy Theory

Attorneys may also be potentially exposed to liability under a conspiracy theory wherein the attorney is found liable as a co−conspirator for the tortious conduct of his client. [*FN:* See McElhanon v. Hing, 728 P.2d 273, 278 (Ariz. 1986) (holding attorney liable for conspiracy with client)., *cert. denied* , 481 U.S. 1030 (1987).] The Arizona Supreme Court has found that a judgment creditor can recover from the attorney whose debtor−client made a fraudulent transfer. [*FN:* See id.] In *McElhanon*, the attorney actively advised and assisted his client, a judgment debtor, and was in fact a transferee of some of the fraudulently transferred assets. [*FN:* See id.] The judgment creditor was successful in obtaining a judgment against the lawyer on a conspiracy to defraud theory. [*FN:* See id.]

Applicable ethical provisions make it clear that an attorney may not counsel his client with respect to conduct the lawyer knows to be fraudulent. [*FN:* See Model Rules of Professional Conduct Rule 1.2(d) (1983).] Although possibly open to some question, the professional conduct rules would seem to clearly prohibit counseling a client with respect to prebankruptcy planning other than perhaps exemption planning. [*FN:* See id.] Model Rule 1.2(d) states, "[a] lawyer shall not counsel a client to engage, or assist a client in conduct that the lawyer knows is criminal or fraudulent." [*FN: Id.*] "Knows" is defined as "actual knowledge of the fact in question, but actual knowledge can be inferred from the circumstances." [*FN: Id.* Terminology 5 (1983). Cf.*In re* Bloom, 745 P.2d 61, 64−65 (Cal. 1987) (disbarring lawyers for mailing explosives to Libya without investigating).] Although many transactions may have multiple motives and "constructive fraud" may not be "fraudulent" within the meaning of Model Rule 1.2(d), a cautious attorney should scrutinize a prospective debtor's asset transfer plan using the same 20/20 hindsight which creditors and the Court will bring to bear on the transactions. Clearly, if the transactions fail the "smell test," the attorney should counsel against them. [*FN:* Cf. Cal. Rules of Professional Conduct 3−210 (1996), which does not use the term "fraudulent" as contained in the Model Rules but simply refers to the "violation of any law" and therefore might be less restrictive. *Id.*]

C. Suspension or Disbarment

Although infrequently seen, disbarment or suspension is a possible result of continuing to represent a client engaged in a fraudulent scheme. For example, in *Townsend v. State Bar of California*, [*FN:* 197 P.2d 326 (Cal. 1948).] an attorney received a three−year suspension for advising a client to convey property fraudulently. [*FN:* See id. at 329.] Similarly, in *Suffolk County Bar Ass'n v. Pfingst (In re Pfingst)*, [*FN:* 385 N.Y.S.2d 806 (2d Dep't 1976).] an attorney was disbarred for participation in fraudulent conveyances in contemplation of bankruptcy. [*FN:* See id. at 807; see also Coppock v. State Bar of California, 749 P.2d 1317, 1330−31 (Cal. 1988) (giving attorney who allowed client to defraud others 90 day suspension, two years probation); Office of Disciplinary Counsel v. Stern, 526 A.2d 1180, 1186 (Pa. 1987) (disbarring attorney for allowing himself to be corrupted by client and corrupting labor leader), *cert. denied* , 488 U.S. 826 (1988).] Even if an attorney lacks any prior disciplinary record, the court may find the violation so offensive so as to warrant disbarment. [*FN:* See People v. Schwartz, 814 P.2d 793, 794 (Colo. 1991) (finding despite lack of prior disciplinary record, federal convictions for conspiracy to commit bankruptcy fraud and other federal offenses warranted disbarment).]

IV. Proposed Course of Action

Whether engaging in pre−filing asset planning or divided loyalties, the message apparently being sent by courts is:

when in doubt, act conservatively and well within the guidelines of professional responsibility. In light of the bankruptcy law requirements of disinterestedness and absence of conflict, professional responsibility rules seem to strongly suggest that the time to deal with divided loyalties is at the outset of the case, and not at a point, perhaps halfway through the case, when decisions have to be made and counsel is required to choose between those loyalties. The professional responsibility rules require that counsel exercise his or her independent professional judgment and that an attorney not place himself or herself in the position of choosing between conflicting loyalties. [*FN:* An attorney may not represent a client where "the representation of that client will be directly adverse to another client." Model Rules of Professional Conduct Rule 1.7(a) (1983). Further, a lawyer may not represent a client where "the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests." *Id.* Rule 1.7(b). Finally, a lawyer must "decline proffered employment if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment[*FN:*]" Model Code of Professional Responsibility DR 5−105(A) (1980).] If such choices have to be made and separate counsel engaged, those decisions should properly be made in the beginning of the case. In the long run, facing these issues early may be more efficient, fairer to competing constituencies, and make decision making by debtors and counsel far less questionable. In addition, an overriding principle which should guide all counsel is the avoidance of the appearance of impropriety. [See Model Code of Professional Responsibility Canon 9 (stating "[a] lawyer should avoid even the appearance of professional impropriety"); see also Roger J. Au & Son Inc. v. Aetna Ins. Co. (*In re* Roger J. Au & Son Inc.), 64 B.R. 600, 605 (N.D. Ohio 1986) (disqualifying counsel upon showing of reasonable possibility of occurrence of specifically identifiable appearance of improper conduct).] Separate counsel for "potentially" conflicted entities is perhaps the only mechanism to achieve this goal.

Finally, the professional conduct rules impose strict requirements upon counsel to preserve and protect the confidences of the client. [*FN:* "A lawyer should preserve the confidences and secrets of a client." Model Code of Professional Responsibility Canon 4. Further, a lawyer must not "reveal information relating to representation of a client." Model Rules of Professional Conduct Rule 1.6(a).] Although sharing confidences of a corporate debtor with its management is inevitable, the representation by the same counsel of multiple affiliates, partners and partnerships, corporations and shareholders, imposes difficult burdens upon counsel to ensure that confidential information is available only to the proper parties and used only for proper purposes.

Conclusion

Attorneys in all areas of law must practice within the bounds of ethical rules, whether they abide by the bare minimum required under state professional responsibility codes, state and federal statutes, or the dictates of their own conscience. However, in bankruptcy practice in particular, attorneys should carefully evaluate any proposed course of action, even before the decision is made to file a bankruptcy petition. Admittedly, the image of bankruptcy itself has changed for the better, [*FN:* See John D. Ayer, How to Think About Bankruptcy Ethics , 60 Am. Bankr. L.J. 355, 365−66 (1986) (commenting that declaring bankruptcy no longer carries the stigma that it formerly did).] but the image of lawyers arguably has declined. [See Nancy B. Rapoport, Seeing the Forest and the Trees: The Proper Role of the Bankruptcy Attorney , 70 Ind. L.J. 783, 783 (1995) (noting abundance of lawyer jokes and cartoons which hint at public's disgust with a "profession that can unabashedly argue both sides of a question with equal vigor and can show absolutely no interest in considering, let alone resolving, important moral or social issues").] Being well informed concerning ethical rules will not only benefit the attorney by preventing any sanctions, but more importantly, uplift the trust of the client and the public in general.