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

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

Bankruptcy is not like the rest of the legal world, in which the name of the client can give the lawyer a real understanding about whom she represents. It’s too facile to say that DIP counsel only represents the DIP and, therefore, she only owes a fiduciary duty to the DIP—because the DIP itself is a fiduciary for the bankruptcy estate. It’s also precious little guidance to say (although we have) that DIP counsel owes no fiduciary duty to the DIP. It’s too simplistic to say that DIP counsel owes no fiduciary duty to the estate.

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

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

Part of the reason that DIP counsel owes something to the estate is that the estate’s funds (read: money coming from the pockets of the unsecured creditors) are paying her fees and expenses. Do not get us wrong: There is an ethics rule in place that clearly states that the person who pays the bill, if that person is not the client, does not get to call the shots in the case.

Here, though, the estate is the raison d’etre of the reorganization: maximizing it, restructuring it and coming out successfully on the other side of chapter 11. The DIP is charged with the rights, powers and duties of a trustee in chapter 11 under 11 U.S.C. §1107. Of course, that statement just puts us back right where we started, in an infinite loop: The DIP itself is a fiduciary for the estate as a whole.

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

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

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

Sure, all lawyers are officers of the court in the larger sense of the concept. We are not supposed to lie to courts, engage in conduct “prejudicial to the courts, the court in the larger sense of the ultimate residual owners. . . .”7 Being counsel for the DIP is different from being counsel for the corporation though because DIP counsel’s behavior as an officer of the court is a significant component of the representation as well.

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

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

c. refusal to pursue claims against insiders. See, e.g., In re DeVlieg Inc., 174 B.R. 497 (N.D. Ill. 1994).
d. failure to properly market or sell estate assets. See, e.g., In re Wilde Horse Enterprises Inc., 136 B.R. 830, 838 (Bankr. C.D. Cal. 1991).
e. conversion, concealment or misuse of estate property. See, e.g., In re Ward, 894 F.2d 771, 776 (5th Cir. 1990); In re Brennan, 187 B.R. 135 (Bankr. D. N.J. 1995); In re Barrie Reed Buick-GMC, 164 B.R. 378 (Bankr. S.D. Fla. 1994).

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

**Duty as an Officer of the Court**

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

**Conclusion: The Law Is the Law**

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


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