1998

The Need For New Bankruptcy Ethics Rules: How Can "One Size Fits All" Fit Anybody?

Nancy B. Rapoport
University of Nevada, Las Vegas -- William S. Boyd School of Law

The Need for New Bankruptcy Ethics Rules: How Can "One Size Fits All" Fit Anybody?

Nancy B. Rapoport

My academic area is bankruptcy ethics, and I'm writing this in conjunction with some testimony that I'm hoping to present to the Ethics 2000 Committee in February. I'd like to alert the Committee to two specific problems that bankruptcy attorneys face. The first problem relates, in most cases, to attorneys representing the non-debtors in a bankruptcy case, and the second problem relates to professionals hired by the bankruptcy estate (primarily in chapter 11 cases).

The Model Rules relating to advocacy presuppose the standard two-party model in which plaintiffs are always pitted against defendants and the attorneys, at the onset of the case, can predict where conflicts are likely to arise.[1] Even in class actions, it's relatively easy to tell that the class action plaintiffs will always be "against" the defendants. Bankruptcy practice differs from the standard two-party model. It probably most closely resembles family law practice in terms of the variety of conflicts issues that can arise.[2] Depending on the issues involved in a particular bankruptcy case for example, (1) the debtor may not *always* be on the opposite side of an issue from the creditors; (2) the secured creditors may be on the same side of one issue as the unsecured creditors, opposed to the unsecured creditors on another issue, and fighting among themselves on yet a third issue; and (3) unsecured creditors, as well, will coalesce on one or more issues and divide on others. Unlike traditional litigation, attorneys at the onset of a bankruptcy case can't always predict potential conflicts of interest, as those conflicts may arise only if certain issues rear their ugly heads.[3]

Complicating the matter is the fact that the only way to be "sure" of avoiding a conflict of interest is to avoid taking on simultaneous representation of more than one client in a bankruptcy case. If there were enough bankruptcy-trained lawyers to go around in bankruptcy cases, that might be the end of the problem. Unfortunately, not all lawyers are skilled at handling bankruptcy cases, and clients – particularly in bankruptcy cases – seek the economies of scale that accompany using a lawyer already familiar with the bankruptcy case. Moreover, the ability to represent even one client in a given bankruptcy case is complicated by the fact that, *depending on how the issues in that case play out,* that single client's interests may be adverse to the lawyer's other current (or former) clients. Because some potential conflicts never arise – based on choices that the parties in the case make – basing a decision to represent a client on the facts established at the onset of the case may result in the under-representation of clients by skilled bankruptcy lawyers. I have suggested before that ethics rules should be revised to be able to handle what I term "dormant, temporary, actual conflicts (DTACs)": conflicts that may arise, if at all, for one issue only in the bankruptcy case and then, when resolved, never reappear.[4] A rule that determines when a client can elect to have a particular lawyer's representation in the face of a DTAC (in essence, treating the DTAC as a temporary issue that might have to be resolved with separate representation for that issue only) would go a long way toward clarifying the matter.

> **[E]thics rules should be revised to be able to handle what I term "dormant, temporary, actual conflicts..**

An ethics rules that covers DTACs would certainly help bankruptcy practitioners. It would also help family law practitioners who represent the same family in a variety of situations. Depending on what legal issues a particular family needs to resolve – adoption, guardianship, custody, divorce – Mom and Dad may side with each other and the children on some issues and will find themselves on opposite sides in other situations. If the likelihood of the "opposite sides" scenario is remote, the family may not want to apply traditional conflicts rules to bar their family lawyer from representing them in multiple matters.[5]

The second ethics problem that is of particular interest to bankruptcy practice involves the question of what, exactly, is the bankruptcy "estate." Under 11 U.S.C. § 327, the bankruptcy estate may hire professionals (e.g., attorneys, accountants). In most chapter 11 cases, the estate is managed by the debtor-in-possession.[6] The professionals appointed under § 327, then, work with the debtor-in-possession but are responsible for working in the best interest of the estate.

What ethics rule will guide the debtor-in-possession's attorney? Although Model Rule 1.13 governs an organization as the client, Model Rule 1.13 presupposes that the lawyer has a clear line of reporting authority when ethics issues arise.[7] Chapter 11 debtors-in-possession, however, don't have such clear lines of authority. The "estate" is considered by some courts simply to be the bundle of rights that

Nancy Rapoport is the Dean of the University of Nebraska College of Law.

the debtor possessed on the date that the petition was filed. Other courts view the estate as representing the interests of the creditors (specifically the unsecured creditors).[8] Complicating this matter is traditional corporate law, which assumes that the ultimate owners of a company are the shareholders and links the corporate lawyer's ultimate duty to the shareholders' interests. For debtors-in-possession that are insolvent, the ultimate owners are likely *not* to be the shareholders. Bankruptcy law considers the unsecured creditors to be the residual owners of insolvent companies.[9] For any insolvent company – in or out of bankruptcy – Model Rule 1.13 needs to clarify the nature of the client. Is the client "the shareholders" only if the company is solvent? Is the client the unsecured creditors if the company is not solvent? What if the lawyer can't tell whether the company is solvent?[10]

I'm on record for suggesting that a separate, uniform code of bankruptcy ethics rules be adopted,[11] and I'm in the process of conducting empirical research designed to discover whether commercial (corporate) bankruptcy ethics issues are so different from consumer bankruptcy ethics issues that a single, separate code of bankruptcy ethics might not resolve these types of problems. I believe that, in the long run, we should depart from a "one-size-fits-all" model of professional responsibility rules and that some practice areas aren't well-served by state codes of ethics. For now, though, I'm mollified by the fact that, through Ethics 2000 and other processes, we're reconsidering how our current model rules work.

ENDNOTES

1. *See* Nancy B. Rapoport, *Turning and Turning in the Widening Gyre: The Problem of Potential Conflicts of Interest in Bankruptcy*, 26 CONN. L. REV. 913 (1994) [hereinafter *Conflicts*].

2. *See Conflicts*, *supra* note1, at 972-75.

3. *Id.* at 917-26.

4. *Id.* at 924-26.

5. Of course, the fun in representing the "family" is the same as representing the "corporation" or the "debtor-in-possession." Who's really the client? *See, e.g.,* C.R. Bowles, Jr. & Nancy B. Rapoport, *Has the DIP's Attorney Become the Ultimate Creditors' Lawyer in Bankruptcy Reorganization Proceedings?*, 5 AM. BANKR. INST. L. REV. 47 , 86-93 (1997) [hereinafter *DIP's Attorney*].

6. 11 U.S.C. § 1107.

7. Model Rule 1.13 states, in part:

   (a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

   (b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization. In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations. Any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization. Such measures may include among others:

   (1) asking reconsideration of the matter;

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

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

   (c) If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly a violation of law and is likely to result in substantial injury to the organization, the lawyer may resign in accordance with Rule 1.16. . . .

   ABA Model Rules of Professional Conduct (1992).

8. *See DIP's Attorney, supra* note 5, at 86-93. For a good discussion of the ethics issues involved in representing pre-debtor insolvent corporations, *see* Bruce A. Markell, *The Folly of Representing Insolvent Corporations: Examining Lawyer Liability and Ethical Issues Involved in Extending Fiduciary Duties to Creditors*, 6 J.BANKR. L. & POL'Y 403 (1997) [hereinafter Markell].

9. *See, e.g.*, Commodity Futures Trading Commission v. Weintraub, 471 U.S. 343 (1985) ("One of the painful facts of bankruptcy is that the interests of shareholders become subordinated to the interests of creditors. In cases in which it is clear that the estate is not large enough to cover any shareholder claims, the trustee's exercise of the corporation's attorney-client privilege will benefit only creditors, but there is nothing anomalous in this result; rather, it is in keeping with the hierarchy of interests created by the bankruptcy laws.").

10. *See, e.g.*, Markell, *supra* note 8; *DIP's Attorney, supra* note 5.

11. Nancy B. Rapoport, *Our House, Our Rules: The Need for a Uniform Code of Bankruptcy Ethics*, 6 AM. BANKR. INST. L. REV. 45 (1998).