DELAWARE BANKRUPTCY INN OF COURT

THE ROLE AND DUTIES OF DEBTORS' COUNSEL UPON THE APPOINTMENT OF A CHAPTER 11 TRUSTEE OR THE CONVERSION OF A CASE

April 8, 2014

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Note of Thanks and Charitable Contribution

I want to thank the Panelist, the Major Contributors and all of the members of the Pupilage Team for their support, insights and comments. This is truly a team effort, and we are excited to be able to present a topic that is rarely discussed or presented, but has wide implications on Chapter 11 practitioners.

Additionally, in the name of the entire Delaware Bankruptcy Inn of Court a donation has been made to the ABI Endowment Fund.

We hope you find our program insightful and enjoyable!

Best,

Bradford J. Sandler

AN INTRODUCTION TO SOME ISSUES IN CHAPTER 7 ASSET CASES CONVERTED FROM CHAPTER 11

By Gary F. Seitz

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The panel before you today will address the key issues arising in the context of conversion: (1) Professional Retention, (2) Privileges, (3) Discovery and – all important - (4) Compensation. My goal is to provide a backdrop and introduction to their presentations.

Traditionally, Chapter 11 of the U.S. Bankruptcy Code was used to facilitate management's rehabilitation of a troubled company, while Chapter 7 offered a streamlined process for liquidating a business under the supervision of an appointed trustee. Today, debtors increasingly are filing for bankruptcy protection in Chapter 11 with no intention of reorganizing in the traditional sense. In other cases, the debtor is simply unable to confirm a plan. A failed Chapter 11 case is often converted to a Chapter 7 case or results in the appointment or election of a trustee who will take control of company assets and operations. Most Chapter 7 cases are non-operating liquidations conducted by an appointed or creditor-elected trustee with little knowledge of the operation of the business of the debtor.

A Chapter 7 bankruptcy typically ends a business's operations. The business may not operate in Chapter 7 without an order under Section 721 of the Bankruptcy Code. Although there are various obligations of the debtor triggered upon conversion, counsel for the debtor may not be paid. The conversion process involves notifying the United States Trustee of the business debtor's intent to convert the bankruptcy to Chapter 7 and asking for input toward a smooth transition.

How to get there: Conversion is not automatic.

Moving to convert to Chapter 7 bankruptcy should be supported with specific reasons. See 11 U.S.C. § 1112(a). Section 1112(b) of the Bankruptcy Code grants a bankruptcy court the authority to dismiss a chapter 11 case or convert it to one under chapter 7, "whichever is in the best interests of creditors and the estate, if the movant establishes cause . . . ." 11 U.S.C. § 1112(b). The term "cause" is not defined by the statute; the examples provided by subsection 1112(b)(4) are meant to be nonexclusive. See, e.g., In re Gilroy, 2008 WL 4531982, at *4 (B.A.P. 1st Cir. 2008) ("Section 1112(b)(4) provides a nonexclusive list of what constitutes cause."); In re Broad Creek Edgewater, LP, 371 B.R. 752, 759 n.8 (Bankr. D.S.C. 2007) ("Section 1112(b)(4) contains a nonexclusive list of sixteen scenarios which constitute cause."); see also In re Brown, 951 F.2d 564, 572 (3d Cir. 1991); Hall v. Vance, 887 F.2d 1041, 1044 (10th Cir. 1989), And therefore factors other than those expressly enumerated in the statute may be considered, and the bankruptcy court has the discretion to reach the appropriate result in a particular case. See, e.g., In re American Capital Equipment, LLC, 2008 WL 4597221, at *2 (3d Cir. 2008) (non-precedential); In re PPI Enterprises (U.S.), Inc., 324 F.3d 197, 211 (3d Cir. 2003). Generally, a court should consider the "totality of the circumstances" in considering relief under section 1112(b). See Perlin v. Hitachi Capital America Corp., 497 F.3d 364, 372 (3d Cir. 2007).

Cause exists to dismiss or convert a chapter 11 case when any of the enumerated provisions of section 1112(b)(4) are applicable. Among the examples of cause are: "material default by the debtor with respect to a confirmed plan." 11 U.S.C. § 1112(b)(4)(N). If cause for relief under section 1112(b) is

demonstrated, and if the provisions of section 1112(b)(2) are inapplicable, a court typically will determine whether dismissal or conversion is more appropriate. See, e.g., In re Superior Siding & Window, Inc., 14 F.3d 240, 242 (4th Cir. 1994) ("A motion filed under this section invokes a two-step analysis, first to determine whether 'cause' exists either to dismiss or to convert the Chapter 11 proceeding to a Chapter 7 proceeding, and second to determine which option is in 'the best interest of creditors and the estate.'"); In re Camden Ordnance Mfg. Co. of Arkansas, Inc., 245 B.R. 794, 798 (E.D. Pa. 2000); In re Mechanical Maintenance, Inc., 128 B.R. 382, 386 (E.D. Pa. 1991),

Determining Assets Subject To Administration: Property Of The Estate In Converted Cases

When a bankruptcy case converts from Chapter 11 to Chapter 7, the case sometimes has assets for a trustee to administer. This kind of case may have issues not found in an asset case initially commenced under Chapter 7. Section 704(1) of the Bankruptcy Code requires the trustee to collect and reduce to money property of the estate. In a converted case it is sometimes more complicated to determine exactly what that property is. While property of the estate is ordinarily fixed as of the date the case is filed, that general rule is more difficult to apply and is subject to exceptions in converted cases.

Section 541(a)(6) of the Bankruptcy Code renders "proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case" property of the estate. The effect of this provision in Chapter 11 cases can be dramatic because debtors under that chapter typically operate a business and acquire and dispose of property. Thus, when a Chapter 11 case converts to Chapter 7 the debtor's schedules, which give a snapshot of its assets as of the date of filing, may not be that instructive regarding what the debtor's assets are as of the date of conversion.

Fed.R.Bank.P. 1019(5) does require the debtor to file a final report and account 30 days after conversion. Among the purposes of that report is to provide the trustee with a more accurate view of what there is to administer. Unfortunately, many debtors never file the report or do not do so timely or completely. Of course, even if the report is filed timely, the trustee in a converted case does not have the luxury of waiting 30 days to take control of the assets, but must do so quickly with the assistance of the debtor and whatever other parties are familiar with the debtor's assets. The importance of early response in determining those assets cannot be too strongly emphasized in converted Chapter 11 cases.

Occasionally Chapter 11 cases convert to Chapter 7 after having first confirmed a plan of reorganization. In addition to the difficulties mentioned above, the trustee in such a scenario must then determine what effect confirmation of the plan has upon assets to administer.

Pursuant to Section 1141(b) of the Bankruptcy Code "except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor." Where neither the plan nor order confirming the plan carve out such exceptions, the estate dissolves upon confirmation. In re Harstad, 39 F.3d 898, 904 (8th Cir. 1994). In that event there is no property for the trustee to liquidate, all assets having vested in the debtor at confirmation. See In re T.S.P. Industries, Inc., 120 B.R. 107 (Bankr.N.D.Ill. 1990)(declining to convert case with confirmed plan for lack of estate to administer). But see Donaldson v. Bernstein, 104 F.3d 547, 554 (3d Cir. 1997) (affirming a decision by the bankruptcy court that allows the chapter 7 trustee to make distributions to creditors in the amounts promised by the confirmed chapter 11 plan); In re Consolidated Pioneer Mortg.

Entities, 264 F.3d 803, 807 n.5 (9th Cir. 2001) (and cases cited); In re Smith, 201 B.R. 267, 274 (D. Nev. 1996), aff'd, 141 F.3d 1179, 1998 WL 133445 (9th Cir. Mar. 20, 1998); In re Hughes, 279 B.R. 826, 829-31 (Bankr. S.D. Ill. 2002); 3 Collier on Bankruptcy, ¶ 348.02[1], at 348-8 (16th ed 2012) ("[C]ourts have not agreed with respect to what property is in the estate when a chapter 11 case is converted to chapter 7 after confirmation of a plan.").

Of course, it does not follow that in such cases the trustee has nothing whatever to administer. Pursuant to Section 541(a)(3) of the Code the trustee still may create a sizeable estate based on an assortment of causes of actions, including preferences and fraudulent conveyances, among others. Even with respect to such causes of action, however, the trustee in a converted Chapter 11 case with a confirmed plan must look closely to the plan and order confirming it for direction as to what, if any, rights the trustee has to prosecute those actions. See In re NTG Industries, Inc., 118 B.R. 606 (Bankr.N.D.Ill. 1990)(Debtor's right to pursue preferences under confirmed plan passed to Chapter 7 trustee upon conversion).

Determining The Universe Of Claims Entitled To A Distribution In Converted Cases

A second issue which is more complicated in a converted case is determining the universe of claims arguably entitled to distribution. During the Chapter 11 case the debtor may have accrued additional unpaid debt to that originally scheduled. While creditors of the debtor in possession (hereafter "DIP creditors") are entitled to share in the ultimate distribution, they cannot do so if they lack notice. Thus, Fed. R. Bank. P. 1019(5) requires the debtor to file a final report of post-petition debts. If the report is filed before the bar date notice is mailed to creditors, there generally is no problem. If, however, the report either is not filed or is filed after the bar date notice has been mailed to creditors, such DIP creditors may be divested of their right to a dividend, unless the trustee takes remedial action.

In the case of no debtor in possession report, the trustee may file a motion requesting the court to compel the filing of the report by the debtor. For non-individual debtors, the trustee may also consider requesting the court to designate an individual as the debtor pursuant to Fed. R. Bank. P. 9001(5) in order to aid compliance. If the debtor in possession report is filed after the bar date has been mailed to creditors, the trustee should request the court to set a bar date for DIP creditors. Remember, only after creditors have had their opportunity to file claims or requests for payment of administrative expenses and the trustee has reviewed and had objections to them determined by the court, is the case ripe for closing.

Determining The Proper Amount Of A Claim In Converted Cases

Another complication in a converted case is determining whether a claim is filed for the proper amount. This is especially nettlesome where a plan has been confirmed before conversion, (but there is an estate to administer because the plan or order confirming the plan did not vest all property in the debtor). In making the determination a preliminary and unresolved question is whether a claim should be allowed based on the amount due when the case was filed or whether the starting point is what the confirmed plan provided.

Suppose, for example, that a creditor had a $100 claim on the date the case was filed. The plan provided for a 10% payment or $10. Suppose, further that the creditor had in fact received $5 in plan payments before the case converted to Chapter 7. Under the first alternative the creditor has a claim for

$95 ($100 minus the $5 plan payment). Under the second alternative the creditor only has a claim for $5 ($10 due under the plan minus the $5 plan payment).

The first alternative appears to disregard the plan and Bankruptcy Code sections which provide that the plan binds creditors. See 11 U.S.C. §§ 1141(a), 1227(a) & 1327(a). Nevertheless, in the Chapter 13 context at least one court has held that the plan is no longer binding if the debtor fails to make plan payments and converts the case to Chapter 7. In re Pearson, 214 B. R. 156, 161 (Bankr. N.D. Ohio 1997).

The second alternative recognizes the binding effect of plans. So, for example, in a serial Chapter 11 case, In re Sportpages Corp., 101 B.R. 528 (N.D. Ill. 1989), the court limited a creditor's claim to the amount remaining to be paid under the debtor's first confirmed plan, although that plan had only been partially performed. The court did not allow the creditor's claim based on the amount due at the time the debtor's first case was filed.

Layer on top of that, Federal Rule of Bankruptcy Procedure 1019(3)—amended in 1987 to overrule the result in decisions such as In re Crouthamel Potato Chip Co., 786 F.2d 141 (3d Cir. 1986), see, e.g., Matter of Fesco Plastics Corp., Inc., 908 F.2d 240, 242-43 (7th Cir. 1990)—which provides that, upon conversion of the case from chapter 11 to chapter 7, only claims actually filed on the claims register will be deemed allowed. See, e.g., In re L. Meyer & Son Seafood Corp., 188 B.R. 315, 319 (Bankr. S.D. Fla. 1995).

Of course, before making a distribution the trustee will still have to determine how much was promised to be paid and how much in fact was paid under the plan. Determining how much was actually paid under a plan is more difficult than determining what was promised to be paid under the plan. In addition to consulting with the plan proponent and creditors, the trustee may review the final report and account of the debtor. Only by so doing will the trustee be in a position to make applicable credits and thereby determine the proper dividend to creditors.

Determining The Priority Of United States Trustee Quarterly Fees In Converted Cases

Another issue that arises only in cases converted from Chapter 11, is the status of unpaid United States Trustee quarterly fees. When a Chapter 11 case converts to Chapter 7 there are often unpaid fees owed to the United States Trustee pursuant to 28 U.S.C. §1930. These fees have the same priority as Chapter 7 costs of administration and Clerk's fees. Because the unpaid fees may be substantial, sometimes there is little or no other money available to pay other claims, even Chapter 11 administrative ones. This has resulted in challenges to the priority of these fees, notwithstanding the apparently clear language of Section 507(a)(1) of the Code.

Further, while the United States Trustee generally files a proof of claim or request for administrative expense for the unpaid fees, such filing is for informational purposes only and is no more required than for Clerk's fees. Therefore, trustees must check with the United States Trustee's Office prior to preparing a proposed distribution to determine whether there are any outstanding United States Trustee fees owed. Under Section 726(a)(1) of the Code this claim may be filed at any time prior to the trustee's distribution and still retain its priority status.

Determining Trustee Fees In Converted Cases

Another complicated wrinkle in a converted case is determining trustee and professional fees. Section 326 imposes a cap on trustee compensation. The formula has changed over the years. The applicable percentage fee cap is determined by the statutory language of Section 326 in effect on the date the case was filed, not the date the case was converted or any other date. Therefore, the case trustee must be cognizant of the applicable fee schedule for the case in question and not assume it is the one currently in effect.

Determining Professional Fees In Converted Cases

The final issue which is more complicated in a converted case is how to deal with fees of professionals from the debtor in possession period. In converted cases there are frequently professionals who have received retainers or interim compensation prior to conversion. In order to close a case all compensation issues must be finally determined. Thus, the trustee may have to request the court to compel professionals to file final fee applications or conduct a review of fees under Section 329 of the Code.

Furthermore, once all professional fees are allowed as final, there may be insufficient funds to pay them. If professionals have received interim allowances, the trustee should consider whether it is appropriate to request the court to order disgorgement so that all claims of the same priority receive the same percentage distribution. While trustees may be reluctant to do so, the integrity of the bankruptcy system requires trustees to consider this issue and reach a principled decision on how best to close a case with this problem.

Conclusion

As the panel will illustrate, there are a number of daunting issues in cases converted to Chapter 7. It is hoped that by providing a better understanding of those issues this panel will increase the likelihood that such cases will be successfully administered.

Outline for Delaware Bankruptcy Inn of Court April 8, 2014 Panel Presentation

RETENTION ISSUES APPLICABLE TO FORMER DEBTOR'S COUNSEL

Retention As Special Counsel

- The Concept of Special Counsel
  - Appointment of a Chapter 11 Trustee terminates the retention of debtor's counsel (along with all other professionals retained by the debtor). To the extent debtor's counsel seeks to continue to serve the Chapter 11 Trustee as special counsel, it must be explicitly retained for that purpose.
    - *Lamie v. U.S. Trustee*, 124 S. Ct. 1023, 1029 (2004) (noting termination of debtor as debtor in possession, terminate a professional's retention under 11 U.S.C. § 327 as a debtor in possession professional).
  - The retention of former debtor's counsel as special counsel by a trustee is explicitly authorized by the United States Supreme Court in *Lamie v. U.S. Trustee*, 124 S. Ct. 1023 (2004).
    - *See Lamie*, 124 S. Ct. at 1032 ("Sections 327 and 330, taken together, allow chapter 7 trustees to engage attorneys, including debtor's counsel, and allow courts to award them fees.").

- Absent Retention as Special Counsel, Former Debtor's Counsel May Not Receive Compensation For Otherwise Appropriate Services Rendered Following Appointment of a Trustee
  - While former debtor's counsel is required to cooperate with a trustee (*See discussion below)*, compensation is not guaranteed unless former debtor's counsel is explicitly retained by the trustee.
    - *In re Weinschneider*, 395 F.3d 401, 403-04 (7th Cir. 2005) (noting that unless counsel is retained under Section 327 of the Bankruptcy Code, counsel will not be compensated for efforts made on behalf of the debtor following appointment of a trustee);
    - *In re Starbak, Inc.*, 2010 WL 3927504, at *7 (Bankr. D. Mass. Sept. 29, 2010) (denying fee application of counsel retained by debtor following appointment of a trustee for purposes of facilitating debtor's cooperation with Chapter 11 Trustee where counsel was not retained by Chapter 11 Trustee under 11 U.S.C. § 327(e)).

- The Impact of Potential Conflicts of Interest on Retention As Special Counsel
  - To the extent former debtor's counsel has an attorney client relationship with both the corporate debtor and the individuals managing its affairs, such counsel may be conflicted from serving as special counsel to the trustee.
    - *In re DeVlieg, Inc.*, 174 B.R. 497 (N.D. Ill. 1994) (holding that under Section 327(e) of the Bankruptcy Code, the trustee can hire an attorney "that has represented the Debtor, for a 'specified special purpose', if the attorney does not represent or hold any interest adverse to the estate and the appointment is in the best interest of the estate.").

- *In re United Utensils Corp.*, 141 B.R. 306, 309 (Bankr. W.D. Pa. 1992) ("An attorney who renders legal advice to an individual associated with the corporation upon matters personally concerning that individual may render himself in a conflict of interest position. Rendition of any such advice will violate the mandate of the Bankruptcy Code under § 327(a) that the debtor may employ attorneys, etc. 'that do not hold or represent an interest adverse to the estate.' Such activity would also violate the mandate under § 327(e) that a debtor's attorney may be employed by the special counsel for a special purpose 'if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.' ").

- However, prudence may weigh against the disqualification of former debtor's counsel as special counsel to the trustee based on the former counsel's knowledge and familiarity with the bankruptcy and related litigation.
  - *See In re O.P.M. Leasing Services, Inc.*, 16 B.R. 932, 938 (Bankr. S.D.N.Y. 1982) ("The realities and practicalities of bankruptcy administration in large, complex cases, such as these, makes it 'doubtful' that a court will sever an established trusteeship over multiple related corporations in cases that are well professed unless there is a showing of actual, present conflict incapable of any other equitable resolution, particularly where, as here, full disclosure of the potential for conflict was made at the outset.");
  - *See id.* (denying a motion to disqualify counsel on the basis of an alleged conflict because disqualification would have created unreasonable delay and expense, particularly where conflict of interest was fully disclosed at the outset).

Representation By Former Debtor's Counsel Of Parties Other Than The Trustee

- Where former debtor's counsel seeks to represent parties other than the trustee, Professional Rules of Conduct may function to preclude such representation because of duties owed by counsel to their former client (the trustee now standing in the shoes of the debtor).
  - For example, Under Delaware Rule of Professional Conduct 1.9, attorneys owe a duty to their former client to:
    - Maintain confidentiality; and
    - Not represent any other party in a "substantially related matter" to the matter he represented his former client in.

  - *See also In re Irwin Jaeger*, 213 B.R. 578, 593-94 (Bankr. C.D. Cal. 1997) (stating that because the trustee succeeds to the confidentiality and loyalty duties former debtor's counsel would otherwise owe to the debtor, debtor's counsel may be precluded from representing other defendants in the bankruptcy case).

Existing Management Must Cooperate With The Trustee But Cannot Be Compelled to Render Services

- *See In re G&G Transport, Inc.*, 1998 WL 898835, at *5 (Bankr. E.D. Pa. Dec. 22, 1998) (existing management has an obligation to cooperate with a Chapter 11 Trustee but cannot be compelled to remain with the company and manage its operations).

Several Bankruptcy Code Sections May Require Former Debtor's Counsel To Cooperate With The Trustee (Regardless Of Whether They Are Compensated)

- 11 U.S.C. § 542(e)
  - Section 542(e) provides, "Subject to any applicable privilege, after notice and a hearing, the court may order an attorney, accountant or other person that holds recorded information, including books, documents, records, and papers, relating to the debtor's property or financial affairs, to turn over or disclose such recorded information to the trustee."

  - Compensation for services ordered under Section 542(e) of the Bankruptcy Code is not required because unlike the turnover provisions of Section 543 which specifically provide that a court shall compensate a custodian, as defined by Section 101(11), for its reasonable fees, expenses and costs in connection with a turnover of the debtor's property, Section 542(e) does not authorize the payment of any expenses which might be incurred in the turnover of the debtor's records.
    - *See In re Hyde*, 222 B.R. 214, 218-19 (Bankr. S.D.N.Y. 1998), *rev'd on other grounds*, 235 B.R. 539 (S.D.N.Y. 1999) (burden of turnover on accountant holding debtor's records not a valid objection to turnover of debtor's records under 11 U.S.C. § 542(e)).

  - For example, former debtor's counsel may be compelled to assemble and deliver the debtor's documents and other information to the trustee.
    - *In re Hechinger Investment Co. of Delaware*, 285 B.R. 601, 613 (D. Del. 2002) (holding that under Section 542(e) a debtor's records held by third parties are subject to turnover to the debtor).

  - In addition, unlike under state law, former debtor's counsel cannot withhold the debtor's documents until their fees are paid.
    - *In re Hechinger Investment Co. of Delaware*, 285 B.R. 601, 613-14 (D. Del. 2002) (noting the legislative history of Section 542(e) suggests that the provision was intended to deprive attorneys, accountants and other third parties holding a debtor's records of the leverage acquired under state laws to receive full payment of professional fees over the debtor's other creditors when the information withheld is necessary to administration of the estate) (citations omitted);
    - *In re American Metrocomm Corp.*, 274 B.R. 641, 652 (Bankr. D. Del. 2002) (same).
  - However, while compensation is not guaranteed, former debtor's counsel can still pursue a lien under applicable state law against the debtor for unpaid fees.

- *See In re American Metrocomm Corp.*, 274 B.R. 641, 650 (Bankr. D. Del. 2002) (noting bankruptcy courts may recognize the existence of a valid lien held by former counsel under state law on the files turned over).

- 11 U.S.C. § 341
  - Section 341 of the Bankruptcy Code requires that where a Chapter 11 case is converted to a Chapter 7 case, a representative of the debtor's estate must appear at a meeting of creditors. If the debtor is not an individual, Delaware local rules require that the entity be represented by counsel.

- 11 U.S.C. § 521
  - The text of Section 521 explicitly requires the debtor and its agents, including its counsel, to cooperate with the trustee insofar as it provides that the debtor shall, "(1) file a list of creditors, and unless the court orders otherwise, a schedule of assets and liabilities, a schedule of current income and current expenditures, and a statement of the debtor's financial affairs; … (3) if a trustee is serving in the case, cooperate with the trustee as necessary to enable the trustee to perform the trustee's duties under this title; (4) if a trustee is serving in the case, surrender to the trustee all property of the estate and any recorded information, including books, documents, records and papers relating to property of the estate, whether or not immunity is granted under Section 344 of this title; and (5) appear at the hearing required under section 524(d) of this title."

- 11 U.S.C. § 330
  - Section 330 provides the court with authority to monitor and supervise court appointed counsel's fees and actions. *Matter of Grabill Corp.*, 983 F.2d 773, 776-77 (7th Cir. 1993)
    - *See, e.g., In re Crivello*, 134 F.3d 831, 835-36 (7th Cir. 1998) (noting former debtor's counsel's refusal to cooperate with a Chapter 7 or Chapter 11 Trustee could constitute a breach of the former counsel's duty to the debtor and thereby authorize the court to reduce the compensation to which the former counsel would otherwise be entitled);
    - *In re Downs*, 103 F.3d 471, 477 (6th Cir. 1996) (holding "the bankruptcy court is vested with the inherent power to sanction attorneys for breaches of fiduciary obligations").

- Bankruptcy Rule of Procedure 2004
  - Bankruptcy Rule 2004 states, "on motion of any party in interest, the court may order the examination of any entity." This rule gives the trustee significant powers to investigate a debtor's financial affairs and, if necessary, could be used against a reluctant former counsel.
    - *See, e..g, In re Fundamental Long Term Care*, 489 B.R. 451, 477(M.D. Fla. 2013) (granting Chapter 7 Trustee's motion under Rule 2004 for turnover of litigation files from debtor's former counsel so it could prepare defense and investigate potential claims).

WHO'S IN CONTROL?:
AN OVERVIEW OF CONTROL OF THE ATTORNEY-CLIENT PRIVILEGE IN CORPORATE AND CONSUMER BANKRUPTCY PROCEEDINGS

By Nathan A. Wheatley[1]

I. INTRODUCTION

The bankruptcy process in general, and a bankruptcy proceeding specifically, can be a fast-paced environment that is not always conducive to careful planning and forethought. In the hustle and bustle of this process, the issue of who possesses the right to assert or waive the attorney-client privilege can often fall by the way side, only to re-surface at inopportune times. This article is intended to provide a brief overview of the attorney-client privilege and who controls and directs the privilege in bankruptcy.

II. THE ATTORNEY-CLIENT PRIVILEGE

A party to litigation may discover evidence which is 1) relevant and 2) non-privileged. Relevant evidence is defined as "evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence."[2] Under this definition, there is a wide range of evidence that is discoverable. However, a key limitation on discovery is the existence of a privilege.[3] If a document or communication is privileged, it may be withheld from opposing counsel and may only be discovered under very limited circumstances.

One of the most well-established forms of privilege is the attorney-client privilege.[4] If information is subject to the attorney-client privilege, the rules of procedure and evidence will not require a party to disclose such privileged information, and will not permit such information to be entered into evidence.[5]

What is the Attorney-Client Privilege?

According to the United States Supreme Court in *Upjohn Company v. United States*, the attorney-client privilege is the oldest of the privileges for confidential communications known to the common law.[6] Its purpose is to "encourage full and frank communication between attorneys

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[2] Fed. R. Evid. 401.

[3] *Hickman v. Taylor*, 329 U.S. 495, 507-508, 67 S.Ct. 385 (1947) (stating that discovery has ultimate and necessary boundaries that come into existence when the inquiry touches on the irrelevant or encroaches upon the recognized domains of privilege.)

[4] *Ross v. City of Memphis*, 423 F.3d 596, 600 (6th Cir. 2005) (attorney-client privilege is the oldest of the privileges for confidential communication known to the common law).

[5] *United States v. Lentz*, 524 F.3d 501, 524 (4th Cir. 2008) (stating that it is a well settled principal of law that confidential conversations between a defendant and his counsel generally are protected by the attorney-client privilege, which afford the communication complete protection from disclosure.)

[6] 449 U.S. 383, 389, 101 S.Ct. 677 (1981).

and their clients and thereby promote broader public interests in the observance of law and administration of justice."[7]

The attorney-client privilege protects the confidentiality of communications between an attorney and the client made for the purpose of securing legal advice.[8] To invoke the privilege, a party must demonstrate: 1) a communication between client and counsel that 2) was intended to be and was in fact kept confidential, and 3) was made for the purpose of obtaining or providing legal advice.[9]

Scope of the Attorney-client Privilege

Any individual, entity, or government body that seeks the advice of an attorney and establishes an attorney-client relationship will be considered a client that has the right to assert privilege over its communications with his/its attorney(s).[10] Moreover, the attorney-client privilege is not limited to oral communications between attorney and client. It also attaches to documents prepared for the purpose of seeking legal advice, legal opinions, legal services, or assistance in a legal proceeding.[11]

However, while the attorney-client privilege extends to communications and documents, it does not protect the discovery of underlying facts.[12] Therefore, while a client cannot be asked what he communicated to his attorney, he may not refuse to disclose factual information simply because it was incorporated into a communication with his attorney.[13]

Finally, the attorney-client privilege extends to communications with both in-house and outside counsel, and can even attach to communications between the corporation's attorney and employees of all levels within a company.[14]

Controlling law

The laws governing attorney-client privilege depend on the type of claim being asserted. In federal courts, the attorney-client privilege is governed by "the principles of the common law as it may be interpreted by the court of the United States in light of reason and experience."[15] However, Federal Rule of Evidence 501 provides that, in civil actions with respect to an element of a claim or defense over which State law controls, privilege shall be determined in accordance with State law.[16] Therefore, if federal law determines the substantive rights of the parties, then

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[7] *Id.*
[8] *In re Grand Jury 90-1*, 758 F. Supp. 1411, 1412 (D. Colo. 1991).
[9] *Pritchard, et al. v. The County of Erie, et al. (in re the County of Erie)*, 473 F.3d 413, 419 (2nd Cir. 2007).
[10] *Ross*, 423 F.3d at 602-603.
[11] *Clarke v. American Commerce Nat. Bank*, 974 F.2d 127, 129 (9th Cir. 1992).
[12] *Upjohn*, 449 U.S. at 395 (citing *Philadelphia v. Westinghouse Electric Corp.*, 205 F. Supp. 830, 831 (E.D. Pa. 1962)).
[13] *Id* at 396.
[14] *Id* at 394-397 (finding privilege of low-level employee questionnaires was necessary for attorneys to render adequate legal advice to their corporate client).
[15] *United States v. BDO Seidman, LLP*, 492 F.3d 806, 814 (7th Cir. 2007).
[16] FED R. EVID. 501; The Federal Rules of Evidence apply in cases under the Bankruptcy Code pursuant to Federal Rule of Bankruptcy Procedure 9017 and Federal Rule of Evidence 1101.

the federal common law of privilege governs; but if the underlying claim or defense is governed by State law, then the State privilege law will control.[17]

Control of Attorney-Client Privilege and Waiver

It is well established that the attorney-client privilege is held and controlled by the client and not the attorney.[18] Therefore, while the attorney-client privilege is most often asserted by the attorney on behalf of the client, ultimately it is the client, and not legal counsel, who may choose to assert the privilege or waive its protections.[19]

The attorney-client privilege may also be waived through a variety of means,[20] including affirmative disclosure,[21] conduct inconsistent with confidentiality,[22] and if the client places in issue a communication that that goes to the heart of a claim in controversy.[23] To determine if the privilege has been waived, courts will examine whether there has been a disclosure of a "significant part" of a privileged communication.[24]

Who is the client?

Given the importance of the control of the attorney-client privilege and the ability to either assert or waive said privilege, identifying the client is a critical task. Until such a determination is made, there may be a dispute as to who has the right to assert the attorney-client privilege.

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[17] *In re Asia Global Crossing, Ltd.*, 322 B.R. 247, 254 (Bankr. S.D. N.Y. 2005).

[18] *See Chirac v. Reinicker*, 24 U.S. 280 (1826).

[19] *See Fisher v. U.S.*, 425 U.S. 391, 96 S.Ct. 1569 (1976); *See Hunt v. Blackburn*, 128 U.S. 464, 9 S.Ct. 125 (1888).

[20] First, privilege is waived if documents are produced without objection to their privileged nature. *See Steen v. First Nat. Bank*, 298 F. 36 (C.C.D. Mo. 8th Cir. 1924). Second, privilege is waived when the client makes a disclosure that is inconsistent with the confidentiality of the attorney-client privilege. *See Hartford Fire Ins. Co. v. Garvey*, 109 F.R.D. 323 (N.D. Cal. 1985). While some courts have found that the disclosure must be voluntary and intentional, other courts have found inadvertent disclosures also waive privilege. *Compare People v. Gardner*, 198 Ca. Rptr. 452 (Cal Ct. App. 1984) *with In re Pioneer Hi-Bred Intern., Inc.*, 238 F.3d 1370 (Fed. Cir. 2001). In some cases, the mere presence of third persons during an otherwise privileged communication will waive privilege. *See State v. Barnhart*, 442 P.2d 959 (Wash. 1968). Third, privilege can also be waived when a client has, "placed in issue a communication which goes to the heart of the claim in controversy." *Chicago Title Ins. Co. v. Superior Court*, 220 Cal. Rptr. 507, 512 (Cal. Ct. App. 1985).

[21] Attorney-client privilege is waived if documents are produced without objection to third-parties, or the substance of privileged communications is revealed to third-parties. *In re Grand Jury Proceedings*, 78 F.3d 251, 254 (6th Cir. 1996). (Affirmative disclosures may not waive the attorney work-product protections. *United States v. AT&T*, 642 F.2d 1285, 1299 (D.C. Cir. 1980).)

[22] In many cases, the mere presence of third persons during an otherwise privileged communication may waive privilege. *See Barnhart*, 442 P.2d 959. While some courts have found that the disclosure must be voluntary and intentional, other courts have found inadvertent disclosures also waive privilege. *Compare Gardner*, 198 Ca. Rptr. 452 *with In re Pioneer Hi-Bred Intern., Inc.*, 238 F.3d 1370.

[23] *Chicago Title Ins. Co.*, 220 Cal. Rptr. at 512.

[24] *In re OM Securities Group Litigation*, 226 F.R.D. 579, 590 (N.D. Ohio 2005); *see In re Perrigo Co.*, 128 F.3d 430, 438 (6th Cir. 1997); *In re Dayco Corp. Derivative Securities Litigation*, 99 F.R.D. 616 (S.D. Ohio 1983) (no waiver of the attorney-client privilege because a "significant part" of an internal investigative report was not released where only a 2-page press release stating that an internal investigation had been conducted and providing only the findings and conclusions was produced).

Where the client is an individual, this question is easily answered. But what of those circumstances, far too common in the business world, where the client is a legal entity? And who within such legal entities possesses the ability to determine how and when the privilege will be asserted?

In the context of corporations, attorney-client privilege becomes more complex. As a legal fiction, a corporation must rely on agents to protect its interests. For solvent corporations, courts have held the attorney-client privilege is controlled by a corporation's management.[25] Members of management must act in a manner consistent with their fiduciary duty to act in the "best interests of the corporation and not of themselves as individuals."[26]

In regard to transitioning management, the Supreme Court has stated "new managers installed as a result of a takeover, merger, loss of confidence by shareholders, or simply normal succession, may waive the attorney-client privilege with respect to communications made by former officers and management."[27] Former managers have no control over the attorney-client privilege, even for communications made during their tenure.[28]

III. ATTORNEY-CLIENT PRIVILEGE IN THE BANKRUPTCY CONTEXT

The protections afforded by the attorney-client privilege are not eliminated by the commencement of a bankruptcy proceeding.[29] The same protections and burdens control within the bankruptcy forum as they apply outside of bankruptcy.[30]

This is not to say that the commencement of a bankruptcy proceeding has no affect upon the attorney-client privilege. Indeed, the ability of an individual or entity to assert the attorney-client privilege may be significantly affected by an insolvency proceeding, because the filing of a bankruptcy proceeding may transfer the authority to exercise or waive the protections of the attorney-client privilege from the debtor to another party. The remainder of this article will address how the federal courts resolve the issue of who controls the attorney-client privilege in the bankruptcy context.

IV. CORPORATE BANKRUPTCY PROCEEDINGS

In *Commodity Futures Trading Commission v. Weintraub*, the United States Supreme Court held that, because the attorney-client privilege is controlled outside of bankruptcy by a corporation's management, the actor whose duties most closely resemble those of management should control the privilege within bankruptcy.[31] Therefore, in the typical corporate Chapter 11

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[25] *See Commodity Futures Trading Commission v. Weintraub*, 471 U.S. 343, 349 (1985) (commenting the attorney-client privilege may be exercised by a solvent corporation's officers and directors).

[26] *Id.* (citing *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919)).

[27] *Id.*

[28] *Id.*

[29] *E.g. In re North Plaza, LLC*, 395 B.R. 113 (S.D. Cal. 2008).

[30] *Id.*

[31] *Weintraub*, 471 U.S. at 251-52 (unless this results in interference with the policies underlying the bankruptcy laws.)

bankruptcy proceeding, and in the absence of a bankruptcy trustee, the debtor in possession controls the corporation's attorney-client privilege.[32]

While interested parties, such as creditors' committees, have attempted to exercise the attorney-client privilege on behalf of a debtor or force a waiver of the attorney-client privilege on behalf of the debtor in possession, courts have held the *Weintraub* analysis does not extend the trustee's power to a creditor's committee.[33] However, under the "common interest privilege," attorney-client privileged communications between a debtor and the unsecured creditors' committee may be protected from disclosure where the communication at issue was in furtherance of the debtor's and the committee's common legal interest.[34] The common interest privilege exists where a communication is made by separate parties in the course of a matter of common interest, the communication was designed to further that effort, and the privilege has not been waived.[35]

Finally, where a trustee, including a liquidation trustee, is appointed in a bankruptcy proceeding, the attorney-client privilege can be expected to pass to that individual, provided that he or she has been vested with control over the debtor's bankruptcy estate or the particular claims to which the privilege applies.[36] This general rule also applies to those situations were an examiner has been appointed by the bankruptcy court,[37] or where a Chapter 7 Trustee is appointed after a Chapter 11 case has been converted to a Chapter 7 case.[38]

In light of the foregoing, best practices require that legal counsel consider both the scope and preservation of the attorney-client privilege in the bankruptcy forum, as well as the effect of the appointment of a trustee or examiner on the issue of control of the privilege. Moreover, because there is relatively little case law that directly addresses the transfer of the attorney-client privilege pursuant to a plan of reorganization or liquidation, when drafting a bankruptcy plan and/or liquidation trust agreement, the wise practitioner will expressly identify who will control the attorney-client privilege post-confirmation, the scope of such privilege, and the authority to assert or waive such privilege.[39]

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[32] *See In re Eddy*, 304 B.R. 591, 599 (Bankr. D. Mass. 2004); *In re Cenargo Int'l, PLC*, 294 B.R. 571, 601 n.37 (Bankr. S.D.N.Y. 2003); *Ramette v. Bame (In re Bame)*, 251 B.R. 367, 373 (Bankr. D. Minn. 2000).

[33] *Official Comm. of Asbestos Claimants of G-I Holding, Inc. v. Heyman*, 342 B.R. 416, 421-23 (S.D. N.Y. 2006).

[34] *In re Value Property Trust v. Zim Co. (In re Mortgage & Realty Trust)*, 212 B.R. 649, 652-54 (Bankr. C.D. Cal. 1997).

[35] *Id.* (*citing In re Bevill, Bresler & Schulman Asset Management Corp.*, 805 F.2d 120, 126 (3rd Cir. 1986); *Griffin v. Davis*, 161 F.R.D. 687, 692 (C.D. Cal. 1995)).

[36] *Weintraub*, 471 U.S. at 358 (the trustee of a corporation in bankruptcy has the power to waive the corporation's attorney-client privilege); *Official Committee of Unsecured Creditors v. Fleet Retail Finance Group (In re Hechinger Investment Co. of Delaware)*, 285 B.R. 601, 613 (D. Del. 2002) (finding that attorney-client privilege is controlled by liquidation trustee, to whom the debtor's litigation claims passed, pursuant to the terms of the plan and liquidation trust agreement.)

[37] *See In re Bioleau*, 736 F.2d 503, 506 (9th Cir. 1984) (finding examiner could waive privilege when granted powers normally held by a trustee).

[38] *Weintraub*, 471 U.S. at 352-54.

[39] *Hechinger*, 285 B.R. at 613 (holding that attorney-client privilege passed to liquidation trustee pursuant to liquidating plan); *See also, In re Hunt*, 153 B.R. 445, 454 (Bankr. N.D. Texas 1992) (refusing to permit the liquidation trustee to waive the debtors' attorney-client privilege and noting that the confirmed plan was silent as to the transfer of the privilege).

V. CONSUMER BANKRUPTCY PROCEEDINGS

While the question of who controls the attorney-client privilege in a corporate bankruptcy can be relatively straight forward, the issue of who controls the privilege in the context of a consumer bankruptcy is far more convoluted. This is because, first, the interests and protected liberties of an individual differ significantly from that of a corporation. Moreover, the Fifth Amendment provides protections to an individual that are unavailable to a corporation. Finally, because of the foregoing, the case law governing the control of the attorney-client privilege in an individual bankruptcy can vary between the federal circuits, and even within the circuits.

Because the Chapter 7 trustee, rather than the individual debtor, controls the assets of the bankruptcy estate in Chapter 7 bankruptcy proceedings, the principal question that must be addressed in any Chapter 7 bankruptcy is whether the debtor or the Chapter 7 trustee controls the attorney-client privilege. Generally, judicial opinions fall within three distinct groups: those that permit the trustee to control the attorney-client privilege in individual bankruptcies; those that give the individual debtor exclusive control over the attorney-client privilege; and the final group, which utilize a balancing test based upon the facts and circumstances of a specific bankruptcy to determine whether the individual debtor or the Chapter 7 trustee controls the privilege. Extreme care should be taken to determine which methodology your jurisdiction follows if the attorney-client privilege is likely to be an issue in a bankruptcy proceeding.

a. Trustee-control of privilege

The first category of decisions are those which hold the attorney-client privilege passes from the individual debtor to the Chapter 7 trustee upon the commencement of the bankruptcy proceeding. In these cases, courts hold that the trustee has absolutely control of the privilege, and may waive or assert the privilege despite objections from the debtor.[40] Thus far, the only reported case where the court employed the "trustee-control" approach in its "pure" form to an individual debtor's Chapter 7 bankruptcy proceeding is the Bankruptcy Court for the Southern District of Florida in the *In re Smith* case.[41]

Courts that have adopted a version of the "pure trustee-control" approach for both individual and corporate bankruptcies generally allow that a trustee must have access to relevant information to make a fair and accurate disposition of a debtor's assets.[42] Therefore, the trustee must be permitted to waive or assert the attorney-client privilege as necessary. The other appeal of this approach is that it provides a "bright line" rule that can be quickly and consistently implemented by the bankruptcy courts. However, critics of this approach argue that it has a chilling effect on communications, and discourage full and frank communications between a debtor and his counsel.[43]

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[40] *See In re Smith*, 24 B.R. 3, 4 (Bankr. S.D. Fla. 1982); e.g., *In re Williams*, 152 B.R. 123, 124 (Bankr. N.D. Texas 1992) (stating that, under confirmed Chapter 11 plan, transfer of right to pursue avoidance actions also effects transfer of evidentiary privileges).

[41] *Id.*

[42] *See, In re Williams*, 152 B.R. at 129.

[43] *Trustees: The Ability to Waive the Debtor's Attorney-Client Privilege*, 106 Com. L.J. 1, *10 (Spring 2001); *Fifteen Years After Weintraub: Who Controls the Individual's Attorney-Client Privilege in Bankruptcy?*, 80 B.U.L. Rev. 635, 661 (April 2000).

b. Debtor-control of privilege

The second, and slightly more accepted, category of cases adopts the opposite approach. In these cases, the debtor rather than the trustee maintains exclusive control over the exercise of the attorney-client privilege.[44] Those courts that have adopted the "debtor-control" approach have generally done so based upon three guiding principals: first, unlike a corporate entity, an individual has an expectation to always remain in control of the attorney-client privilege; second, an individual has a greater interest in privacy than a corporate entity; and finally, the ability of a Chapter 7 trustee to waive the attorney-client privilege of an individual debtor would likely have a chilling effect on communications between an individual and his attorney.[45]

Like the "trustee-control approach, this position has the advantage of providing a black-letter rule of law that permits consistent application. However, critics of this approach are quick to point out: 1) the "expectation of control of the privilege" argument is invalid because both corporate entities and individuals can possess expectation and beliefs concerning their control of the attorney-client privilege; 2) not all debtors can be expected to be forthcoming to the bankruptcy court, and may use the attorney-client privilege as a method for concealing assets or defrauding the bankruptcy court; and 3) not all debtors can be expected to know when it may be in their best interests to waive the attorney-client privilege.[46]

c. Balancing test

The final category of cases utilizes a so-called "balanced approach" to determining who controls the attorney-client privilege by considering the unique facts of each case. Under the balancing test, the court weighs the interests of the debtor in preserving the privilege, and the potential harm that could result from its waiver, against the ability of the trustee to carry out his statutory duties and uphold the underlying policies of the bankruptcy code.

In rejecting the bright-line approaches of the preceding two doctrines, courts employing the balance test consider the interests of the debtor in preserving the attorney-client privilege, and weigh such interests against the obligations imposed upon the Chapter 7 trustee and the goals of a bankruptcy proceeding. In application, this test can have very different results depending upon the circumstances of each case. For example, in *In re Bazemore*, generally regarded as a seminal case for the balance test approach, the Bankruptcy Court for the Southern District of Georgia permitted the Chapter 7 trustee to waive the attorney-client privilege in order to permit the examination of the debtors' legal counsel regarding his pre-petition representation of the debtors in a personal injury lawsuit.[47] In reaching its decision, the *Bazemore* court considered *Weintraub's* mandate that such inquiry requires balancing the interests of "a full and frank discussion in the attorney-client relationship and the harm to the debtor upon a disclosure with the trustee's duty to maximize the value of the debtor's estate," and found that, because the trustee wished to waive the attorney-client privilege for the purposes of determining whether the

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[44] E.g., *McClarty v. Gudenau*¸ 166 B.R. 101, 102 (E.D. Mich. 1994) (holding that debtor, and not trustee or bankruptcy court, can determine whether to waive attorney-client privilege); *In re Silvio De Lindegg Ocean Dev. of America, Inc*., 27 B.R. 28 (Bankr. S.D. Fla. 1982).
[45] *McClarty*, 166 B.R. at 102 (citing *In re Hunt*, 153 B.R. at 450-53).
[46] *Trustees: The Ability to Waive the Debtor's Attorney-Client Privilege*, 106 Com. L.J. at 13-14.
[47] *Moore v. Eason (In re Bazemore)*, 216 B.R. 1020 (Bankr. S.D. GA 1998).

debtors have a claim against their attorney and insurer, no harm would come to the debtors.[48] In contrast, permitting the trustee to waive the privilege would permit the trustee to comply with her statutory duty to investigate the potential assets of the debtors' estates and maximize their value.[49]

In contrast to the *Bazemore* case, the Bankruptcy Court for the Northern District of Ohio in *In re Miller* applied the balance test set forth in *Bazemore* and held that, because the Chapter 7 trustee and the debtors were in an adversarial relationship, it would be improper to permit the trustee to waive the attorney-client privilege.[50] In *Miller* the Chapter 7 trustee was attempting to set aside the debtors' Chapter 7 discharged based upon the debtors' receipt and expenditure of estate assets post-discharge.[51] Additionally, there was a very real possibility that the information obtained by the trustee as a result of his waiver of the privilege could be used against the debtors in a subsequent criminal prosecution for violations of the Bankruptcy Code.[52] As a result, the bankruptcy court held that, because the potential harm to the debtors was particularly acute and because the trustee would not be significantly hampered in his representation of the estate if the privilege was not waived, the Chapter 7 trustee was not authorized to waive the attorney-client privilege.[53]

While the *Bazemore* and the *Miller* cases reached different results, they both employ a balancing test based upon the language of the *Weintraub* decision and are indicative of the dominant trend in bankruptcy case law in Chapter 7 bankruptcy proceedings.[54]

VI CONCLUSION

The importance of the attorney-client privilege to a debtor, and the variance between the treatment of corporate and individual debtors with regard to control of the privilege, necessitates a bankruptcy practitioner carefully weigh considerations of the attorney-client privilege prior to the commencement of a bankruptcy proceeding, or as soon thereafter as practicable.

Control of the corporate debtor's attorney-client privilege will pass to that entity which most closely resembles management, whether that entity is the debtor-in-possession or a trustee. The loss of control of the attorney-client privilege can have unfortunate and unpredictable results on a corporate debtor. Therefore, as part of insolvency planning, management of the potential corporate debtor should be informed of, and carefully weigh the risks of, the potential loss of control of the attorney-client privilege and consider its impact on the corporate entity. Similarly, a bankruptcy practitioner must consider the potential effect of the threatened or actual appointment of a Chapter 7 or Chapter 11 trustee upon the privilege. Finally, when preparing a proposed bankruptcy plan, the debtor should expressly identify whether the attorney-client

[48] *Id.* at 1024.
[49] *Id.* at 1024-25.
[50] *French v. Miller (In re Miller),* 247 B.R. 704 (Bankr. N.D. Ohio 2000).
[51] *Id.* at 706-7.
[52] *Id.* at 710
[53] *Id.* at 710-11.
[54] *In re Pearlman,* 381 B.R. 903, 910 (Bankr. M. D. Fla. 2007) (stating that the majority of courts employ a balancing test whereby "the specific facts of a case are evaluated and balanced, including the risk of harm to the debtor versus the benefit to the estate.")

privilege will be conveyed to a non-debtor party, as well as the scope and potential impact of such a transfer; in the absence of such provision, established case law will control.

With regard to the consumer debtor, the current majority approach clearly favors the balancing test for determining whether the debtor or a trustee may exercise control over the attorney-client privilege. Because this test requires consideration of the unique facts surrounding each case, prior to commencing a bankruptcy proceeding counsel for a consumer debtor should consider what effect, if any, transfer of control of the attorney-client privilege to a trustee may have upon his client and how the debtor will respond to such a request by a trustee. Conversely, prior to a trustee attempting to waive the attorney-client privilege on behalf of a consumer debtor, the trustee should be prepared to articulate the bases upon which a bankruptcy court may decide that the interests of the individuals in maintaining the privilege are overcome by the duties and obligations set forth within the Bankruptcy Code.

Finally, whether representing a corporate debtor, consumer debtor, or trustee, a bankruptcy attorney must carefully consider the issues surrounding the attorney-client privilege and its potential impact upon the client. As in most things, the keys to success with regard to the issues surrounding privilege are research, deliberation and preparedness.

COUNSEL'S DUTIES UPON APPOINTMENT OF A CHAPTER 11 TRUSTEE/CONVERSION TO CHAPTER 7: DOCUMENT PRODUCTION & DOCUMENT PRESERVATION

I. INTRODUCTION

The fiduciary duties of a DIP and DIP counsel are defined and described by the Bankruptcy Code and accompanying Rules, the Rules of Professional Conduct and applicable case law. It is well settled that DIP counsel owes significant fiduciary duties to its client. Additionally, as the law currently stands, upon the filing of a Chapter 11 petition, DIP counsel's fiduciary duties expand to parallel many of the fiduciary duties of the DIP itself.

How are DIP counsel's fiduciary duties affected upon conversion or appointment of a Chapter 11 trustee?

It should be noted that the scope of this inquiry is limited to the issues of document production and preservation.

II. COUNSEL'S DUTIES WITH RESPECT TO DOCUMENT PRODUCTION & PRESERVATION (including electronic information)

Counsel's duties with respect to document production and preservation can be found in the Rules of Professional Conduct and applicable case law. Rule 1.15 of the Delaware Rules of Professional Conduct imposes a duty on counsel to hold, safeguard and preserve for a period of 5 years, property belonging to a client or third party.

Additionally, case law indicates that bankruptcy counsel has a professional ethical obligation to assist a debtor in fulfilling its duties under the Bankruptcy laws.[1]

[1] *See e.g. In re Brierwood Manor, Inc.*, 239 B.R. 709, 716 (Bankr. D. N.J. 1999) (Holding that counsel for former DIP may not be compensated for services provided to the debtor post conversion, unless such services assisted the debtor in fulfilling its duties under § 521); *In re Morey*, 416 B.R. 364, 365 (Bankr. D. Mass. 2009) (Holding that counsel for a Chapter 7 debtor is under a professional ethical duty to assist the debtor with her duty of cooperation with the Trustee); *Robb v. Sowers (In re Sowers)*, 97 B.R. 480, 487, 488 (Bankr. N.D. Ind. 1989) ("Among the obligations counsel assumes by representing a bankruptcy debtor is that of assisting the client to fulfill the duties imposed upon it by the Bankruptcy Code."); *Houghton v. Morey (In re Morey)*, 416 B.R. 364 (Bankr. D. Mass. 2009) (The Court disqualified debtor's counsel from representing non-debtor defendant in a fraudulent transfer adversary proceeding brought by the debtor's trustee in bankruptcy "[b]ecause [debtor's counsel] cannot fully and adequately assist the Debtor with her duty of cooperation to the Trustee and the bankruptcy estate while simultaneously representing [an entity whose interests potentially conflict with the Trustee]…");

If counsel fails to fulfill those duties, they may be subject to sanctions by the Bankruptcy Court. [2]

What are a debtor's duties with respect to document production?

In general, debtors are obligated to produce documents in the context of an adversary case or 2004 examination. Rules 7026 and 7034 of the Federal Rules of Bankruptcy Procedure set forth the document production rules in the context of an adversary case. Rule 7026 requires litigants in an adversary case to comply with the initial disclosure requirements set forth in Federal Rule of Civil Procedure 26. Specifically, Federal Rule of Civil Procedure 26 requires litigants to provide one another with "a copy-or a description by category and location- of all documents, electronically stored information, and tangible things that the disclosing party has in its possession, custody, or control and may use to support its claims or defenses…" Further, Rule 7034 provides that Federal Rule of Civil Procedure 34 applies in adversary actions. Specifically, Federal Rule of Civil Procedure 34 provides that litigants may request from one another the production of "documents or electronically stored information-including writing, drawing, graphs, charts, photographs, sound recordings, images, and other data or data compilations-stored in any medium from which information can be obtained…"

Section 521 of the Bankruptcy Code, Federal Rule of Bankruptcy Procedure 4002, and Local Rule 4002-1, all impose additional duties upon a debtor where a trustee has been appointed to serve in the case. Specifically, debtors are obligated to cooperate with the trustee and provide certain documentation to the trustee. Some Courts have gone so far as to say that a debtor's duty to cooperate with the trustee is actually shared by counsel.[3] Those courts reason that debtor's counsel has a fiduciary duty to the bankruptcy estate, even upon appointment of a trustee. The majority view, however, is that, upon appointment of a Chapter 11 trustee/conversion to Chapter 7, counsel for the debtor is relieved of any obligations it may have had to the bankruptcy estate while acting as DIP counsel.[4]

See also In re Cochener, 360 B.R. 542 (Bankr. S.D. Tex. 2007) (debtor's counsel, as an agent of the debtor, is not only obligated to assist their client in fulfilling their duties under the bankruptcy laws, but that debtor's counsel actually shares those same duties).

[2] *In re Cochener*, 360 B.R. 542 (Bankr. S.D. Tex. 2007).

[3] *See Agresti v. Rosenkranz (In re United Utensils Corp.)*, 141 B.R. 306, 309 (Bankr. W.D. Pa. 1992) ("An attorney for the [chapter 7] debtor has a fiduciary duty not only to the debtor, but has a fiduciary obligation to act in the best interest of the entire estate, including creditors."); *See also In re Cochener*, 360 B.R. 542 (Bankr. S.D. Tex. 2007).

[4] *See In re Brier Wood Manor, Inc.*, 239 B.R. 709, 716 (Bankr. D.N.J. 1999) ("In a chapter 11 reorganization, the debtor in possession has a fiduciary duty to act in the best interest of the estate and creditors… Upon conversion of the chapter 11 case to liquidation under chapter 7…the interests of the estate become the responsibility of the chapter 7 trustee."); *In re Nidiver*, 217 B.R.

What are a debtor's duties with respect to document preservation?

In addition to the implicit obligations of debtors to preserve certain documentation in connection with their document production duties discussed above, Federal common law imposes an express duty to preserve relevant documents when litigation becomes reasonably anticipated.[5] As for counsel, they "must oversee compliance . . . monitoring the party's efforts to retain and produce the relevant documents."[6] Specifically, attorneys are obligated to ensure all relevant documents are discovered, retained, and produced.[7]

The term often used to describe a litigant's failure to properly preserve evidence is called "spoliation." A finding of spoliation can result in an adverse inference against the spoliator, sanctions, or even denial of discharge (in the context of a chapter 7 case).[8]

Upon appointment of a Chapter 11 trustee, there is often an increased likelihood of litigation, and as such, a possible increased need for document preservation. Counsel

581, 583 (Bankr. D. Neb. 1998) (Finding that in a Chapter 7 case, the bankruptcy estate is administered by a trustee, and that "[d]ebtors counsel will not represent the bankruptcy estate, will not have a fiduciary duty to creditors, and will not be employed as a professional person to render services to be compensated from the bankruptcy estate."); *In re Doors & More, Inc.*, 126 B.R. 43, 45 (Bankr. E.D. Mich. 1991) ("[I]n Chapter 7, court approval of the debtor's attorney is not required because neither the debtor nor the debtor's attorney have any fiduciary obligation to the bankruptcy estate."); *Burtch v. Ganz (In re Mushroom Transp. Co.)*, 366 B.R. 414, 451 (Bankr. E.D. Pa. 2007) ("[O]nce a chapter 7 trustee is appointed there is no longer a debtor in possession; the chapter 7 debtor is not a fiduciary; and counsel for the chapter 7 debtor does not represent the trustee… Thus, debtor's counsel is not in a fiduciary relationship to the chapter 7 trustee upon conversion of the case."); *Houghton v. Morey (In re Morey)*, 416 B.R. 364, 367 (Bankr. D. Mass. 2009) ("Some courts have held that… an attorney for the debtor [in the context of a Chapter 7 case] has a fiduciary duty not only to the debtor, but has a fiduciary obligation to act in the best interest of the entire estate, including creditors. This Court respectfully disagrees and believes that the only duty which counsel for the debtor assumes is to his or her client.") (*internal quotations and citations omitted*).

[5] *See e.g. Quintus Corp. v. Avaya, Inc. (In re Quintus Corp.)*, 353 B.R. 77 (Bankr. D. Del. 2006) *Citing Howell v. Maytag*, 168 F.R.D. 502, 505 (M.D. Pa. 1996) (holding that a party who has reason to anticipate litigation has an affirmative duty to preserve evidence which might be relevant to the issues in the lawsuit); *Zubulake v. UBS Warburg LLC*, 220 F.R.D. 212, 2018 (S.D.N.Y. 2003) (Holding once a party reasonably anticipates litigation, it has a duty to suspend routine document destruction and establish a "litigation hold" to ensure the preservation of relevant documents.)

[6] *Zubulake v. UBS Warburg LLC*, 229 F.R.D. 422, 432 (S.D.N.Y. 2004).

[7] *Zubulake v. UBS Warburg LLC*, 229 F.R.D. 422 (S.D.N.Y. 2004).

[8] *See e.g. Hechinger Inv. Co. of Del., Inc. v. Universal Forest Prods. (In re Hechinger Inv. Co. of Del., Inc.)*, 489 F.3d 568 (3rd Cir. 2007); *Schmid v. Milwaukee Elec. Tool Corp.*, 13 F.3d 76, 79 (3d Cir. 1994); *In re Siegmund Strauss, Inc.*, Case No. 13-10887 (MG), 2013 Bankr. LEXIS 2880 (Bankr. S.D. N.Y. July 17, 2013); *Anderson v. Wiess (In re Wiess)*, 132 B.R. 588 (Bankr. E.D. Ark. 1991).

must be wary of this fact, and act accordingly.

III. CONCLUSION

Bankruptcy counsel has a host of substantive legal pitfalls that must be avoided. As such, it is important for counsel to be cognizant of the breadth of their fiduciary duties while in Bankruptcy, and additionally, how those duties may change upon appointment of a Chapter 11 trustee/conversion to Chapter 7.

COMPENSATION FOR DEBTOR'S COUNSEL FOR WORK AFTER CONVERSION OR APPOINTMENT OF A CHAPTER 11 TRUSTEE

I. *Lamie* Held that Appointment of a Chapter 7 Trustee Terminates: (i) Debtor's Debtor-in-Possession Status, and (ii) Debtor Attorney's Retention Under Section 327 of the Bankruptcy Code

In *Lamie v. U.S. Trustee*, 540 U.S. 526 (2004), the Supreme Court resolved a Circuit split over the interpretation of the 1994 amendments to section 330(a) of 11 U.S.C. §§ 101, *et seq.* (the "Bankruptcy Code"). The prior version of section 330(a), permitted reasonable compensation and expense reimbursement to various parties, including "the debtor's attorney" or a "professional person employed under section 327 or 1103" of the Bankruptcy Code. The 1994 amendments removed the reference to "the debtor's attorney," and gave rise to a Circuit split regarding whether a debtor's attorney could be compensated unless such attorney was employed under section 327.

The Supreme Court in *Lamie* concluded that employment under section 327 of the Bankruptcy Code was required for a debtor's attorney to be compensated by the Bankruptcy estate. Because appointment of a Chapter 7 trustee "terminated [the debtor's] status as debtor-in-possession and so terminated [the attorney's] service under § 327 as an attorney for the debtor-in-possession," the attorney could not be compensated from estate funds in the absence of employment by the trustee and approval by the court pursuant to section 327. 540 U.S. at 532.[1]

[1] Courts have held that *Lamie* also applies upon appointment of a Chapter 11 trustee. *See In re Int'l Gospel Party Boosting Jesus Groups, Inc*., 487 B.R. 12, 15 (D. Mass. 2013) (citing cases).

These materials provide an outline of strategies debtor's counsel may employ to get paid for work post-conversion or appointment after *Lamie*.[2]

II. Getting Paid After *Lamie*

- Payment from Retainer

  - *In re Channel Master Holdings, Inc.*, 309 BR 855, 859 n.3 (Bankr. D. Del. 2004) ("Although the Supreme Court has held that, after conversion to chapter 7, debtor's counsel fees may not be paid by the estate, it did acknowledge that those fees may be paid from a retainer received prior to conversion. Since the post-conversion fees and expenses sought by counsel for the Debtors are less than the remaining retainer, they may be paid from it.") (internal citation omitted). Certain courts in other jurisdictions courts have limited the so-called "retainer exception" to a flat fee retainer. *See In re CK Liquidation Corp.*, 343 B.R. 376, 383 (D. Mass. 2006) (holding that debtor's attorney could not be paid from security retainer for post-conversion work).

  - Query whether debtor's counsel can ask for a post-petition pre-conversion retainer to cover these fees.

- Employment Under Section 327(e) as Special Counsel to the Trustee[3]

  - In *Lamie*, the Supreme Court noted that sections 327 and 330 allow Chapter 7 trustees to "engage attorneys, including debtors' counsel, and allow courts to award them fees." 540 U.S. at 537 (citing sections 327(a) and (e)).

[2] This outline is designed to provide a survey of recent case law and suggested strategies for practitioners. It is not intended to, and does not, express the view of the authors or their firms as to whether or to what extent such payment should be allowed.

[3] Ethical and practical issues regarding retention are discussed more fully in the accompanying "Retention Issues Applicable to Former Debtor's Counsel" materials prepared by Samuel L. Closic and R. Stephen McNeill.

- Under section 327(e), the trustee may employ the debtor's attorney "for a specified special purpose . . . if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed." 11 U.S.C. § 327(e).

- Ethical and practical concerns:

  - Employment by the trustee may not make sense if the attorney is really representing the debtor.

  - Conflicts of interest

    - *See In re Hart Oil & Gas, Inc.*, No. 12-13558, 2013 WL 3992252, at *4 (Bankr. D. N.M. Aug. 2, 2013) (reasoning that "[b]ecause of potential solvency, the Debtor has standing in the case, is an interested party, and like secured and unsecured creditors, constitutes an 'interest adverse' to the estate" and concluding that the debtor's counsel could not represent the Chapter 11 trustee).

    - Other potential conflicts/concerns.

- Approval of Payment by Chapter 7 or Chapter 11 Trustee?

  - *See Lamie*, 540 U.S. at 537 ("Section 327's limitation on debtors' incurring debts for professional services without the Chapter 7 trustee's approval is not absurd."); *In re Schiff*, No. 04–14811, 2010 WL 3219535 (Bankr. S.D.N.Y. Aug. 10, 2010) (ordering payment of fees incurred by debtor's counsel following appointment of chapter 11 trustee where, *inter alia*, trustee had agreed that debtor's counsel should be paid from surplus funds, and retention of counsel by debtor had also been approved by the court after appointment of chapter 11 trustee, but ultimately not reaching the *Lamie* issue).

  - Consider whether, as a practical matter, pre-approval is possible. If fee application is not objected to, do courts interpret this as implicit consent, since some courts have been allowing these fees based on no objection?

- Substantial Contribution

    - *In re The Village at Penn State Retirement Community*, Case No. 11-08005 (Bankr. M.D. Pa. Sept. 12, 2013).

    - However, the language of section 503(b)(3)(D) only references chapter 9 and 11 cases, not cases converted to chapter 7. In addition, it applies to "a creditor, an indenture trustee, an equity security holder, or a committee . . . ."

- Other

    - Attorneys' liens. *But see*, *e.g.*, *In re CK Liquidation Corp.*, 343 B.R. at 383 (rejecting debtor attorney's argument that retainer was encumbered by state law property lien, and unaffected by the debtor's conversion to chapter 7).

    - Reaffirmation for the debt of attorneys' fees.

- Seeking Payment From the Debtor

    - *In re Schiff*, 2010 WL 3219535, at *6 (stating that "this Court need not reach the legal issue raised by *Lamie* because there appears no dispute that a debtor's counsel is not precluded from seeking payment from the debtor personally after dismissal of a case," and holding that reasonable post-conversion fees should be payable upon dismissal from surplus to be distributed to debtor).

    - *But see In re Int'l Gospel Party Boosting Jesus Groups, Inc.*, 487 B.R. 12, 15 (D. Mass. 2013) (holding that debtor's counsel could not be compensated from estate, including from surplus funds, for services incurred after appointment of chapter 11 trustee).[4]

[4] The court also distinguished *In re Lewis*, 346 B.R. 89, 102 (Bankr. E.D.Pa. 2006), which had awarded fees to debtor's counsel following dismissal of an individual Chapter 13 proceeding pursuant to section 349(b), noting that "11 U.S.C. § 330(a)(4)(B) makes compensation available to Debtor's counsel in individual Chapter 13 proceedings 'based on a consideration of the benefit and necessity of such services.'" 487 B.R. at 17.