Tuesday, October 20
4:30 pm–6:00 pm

108 To The Lifeboats! Ethical Issues In Corporate Insolvency and Near Insolvency

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BearingPoint

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Faculty Biographies

Karen Frame

Karen Frame is associate general counsel and assistant secretary at Market Force Information in Louisville, CO. Ms. Frame is responsible for litigation, employment issues, mergers and acquisitions, contracts, and intellectual property.

Prior to joining MFI, Ms. Frame was senior director of litigation and associate general counsel at Brocade/McDATA, where she advised all departments, oversaw litigation, trained employees and management on compliance issues, drafted and implemented policies/procedures, managed IP matters and outside counsel, and assisted the general counsel with board governance, SEC matters, and managing the contracts/legal team. Prior to Brocade, Ms. Frame was Covad's senior counsel of government and external affairs, where she conducted complex regulatory arbitrations and proceedings against Qwest/Verizon before state regulatory bodies and participated in federal/state court litigation. Previous to Covad, Ms. Frame headed up the legal department at Carrier Access, a publicly-traded equipment manufacturer. Ms. Frame also spent time in private practice, where she built a reputable business and real estate practice, and was President/CEO of two technology start-ups. Before moving to Colorado, Ms. Frame was a business law adjunct professor at the University of Illinois College of Commerce, and she is a former assistant state's attorney.

Ms. Frame currently serves as an adjunct instructor at the University of Colorado School of Law, and she mentors teens in the justice system.

Karen holds a JD from the University of Illinois College of Law, studied international law at Oxford University, and earned her BS from Indiana University.

Monica Palko
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BearingPoint

Evan Slavitt

Evan Slavitt is vice president for business and legal affairs for AVX Corporation in Myrtle Beach, South Carolina.

Prior to this position, Mr. Slavitt was trial attorney in private practice in Boston. Mr. Slavitt began his career trial attorney in the antitrust division of the U.S. Department of Justice and as an assistant United States attorney for the District of Massachusetts.

Mr. Slavitt is a frequent writer and lecturer, including the ABI Litigation Skills Symposium, and he was one of the founding members of the ACC’s Ethics and Compliance Committee.

Mr. Slavitt received a BA and a MA from Yale University. He received his JD from Harvard Law School where he was an editor of the *Harvard Law Review*.

To the Lifeboats

Outline of Presentation

I. Introduction – ES

- General Topic
- Panelists

II. Overview of Key Concepts – ES

- Insolvency
- Chapter 11/7
- Automatic stay
- Trustee/DIP
- Preference Actions
- Insiders
- The “Plan”

III. In-House Counsel to the Debtor

- Whom do you represent?
- Do your duties change as the company gets closer to insolvency?
- After filing, who is your client?
- What happens to the privilege?

- What if the Board does not meet its fiduciary duty?
- What if you know of preferences?

IV. In-House Counsel to the Lender

- How much pressure is too much?
- What can you require?
- The issue of personal guarantees

V. In-House Counsel to the General Creditor

- Re-cutting the deal?
- Cunning plans to avoid preferences
- The issue of guarantees
- Can you halt services to debtor company? What language needs to be part of your agreement with debtor company from the get-go?
- Selling claims to third parties
- Coordinating with other creditors
- The role of counsel to the creditor's committee

VI. In-House Counsel to the Acquiring Company

- How much coordination can you do?
- Can you pay off other entities?
- What about other side deals with putative management?

SCENARIO A

Counsel to the Debtor

Debtco, a public company, has been losing money for the last two years. The auditors are discussing a "going concern" qualification. There is a board meeting to discuss the possibility of a bankruptcy filing under Chapter 11.

Question A1: Is the very fact of the auditors' views together with the board meeting a disclosable event that In-house Counsel must insist on?

During the board discussion, the CEO strongly advocates waiting two months before any such filing. You suspect that the CEO wants to delay the filing until more than one year has passed since the big bonus he received last year.

Question A2: Are you obliged to bring this to the attention of the Board? Should you inform the board that the CEO is disqualified from voting?

The next day Debtco's bank representatives arrive to discuss extension of the company's line of credit. During the course of the negotiations, no questions are asked about the course of the audit or the board meeting and the other company representatives do not raise the issue.

Question A3: Do you need to take the company representatives aside to tell them that failure to discuss these issues could be a material misrepresentation? If they disagree, what obligations do you have?

The president of the company comes to your office and wants to have a confidential discussion with you. He asks you whether the trustee in bankruptcy has the power to retroactively waive the privilege.

Question A4: What do you say?

Debtco files for bankruptcy but it has two wholly-owned subsidiaries that are financially solvent which do not file. There are some intercompany claims back and forth.

Question A5: – What is the status of the In-house counsel who has acted as counsel to Debtco and its subsidiaries? Can she continue to represent any of the entities? If so, what rules apply?

SCENARIO B

In-House Counsel to the Creditor

You are In-house counsel to Fatcatco. One of the company's larger customers, Failureco, has been receiving substantial adverse publicity about its financial condition. Your collection department is concerned and tells you that the company is running late on its payments and that they have heard the same is true for other suppliers.

Question B1: You happen to own some shares of Failureco. Can you call your broker to sell them?

In-house counsel to Failureco calls. She wants to work out something. At first, she simply asks for an agreement that extends payment terms.

Question B2: Is this a good idea?

Counsel then suggests the following. Failureco will order some product for a COD delivery. For this one shipment, Failureco will pay 150% of normal price which, by happenstance is precisely the amount that is past due.

Question B3: You can give Failureco's in-house counsel points for cleverness, but can your company enter into this agreement?

SCENARIO C

In-House Counsel to the Lender

Failureco has disclosed that it is in violation of several covenants and is contemplating a bankruptcy filing. There are two credits out, a secured loan, and an unsecured line of credit.

Question C1: Is there anything unethical about insisting that all payments be made to the unsecured line preserving the maximum amount secured?

The lender is willing to extend the terms of the loan, but only on the condition that there is an understanding that it will also be the Debtor In Possession finance entity.

Question C2: Is the above a legitimate condition? Does it need to be disclosed to the junior lenders?

Failureco's president has a loan outstanding for a parcel of real estate. As an inducement for further cooperation during the bankruptcy, the president seeks release from his personal guaranty?

Question C3: Any problems?

SCENARIO D

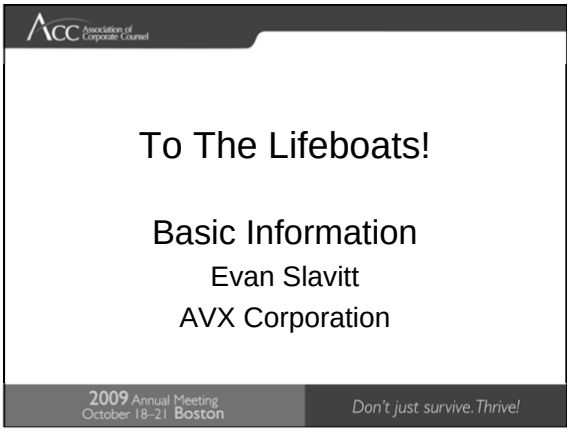
In-House Counsel to the Bidder

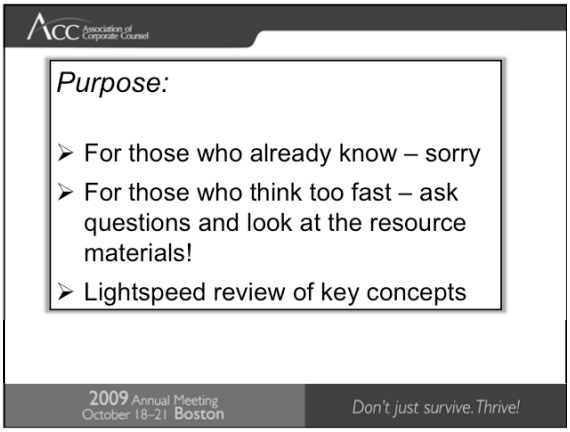
You represent Vultureco. It is interested in some of the assets of Debtco, but not interested in others. Another company, HyenaCo, is interested in those assets, but not the ones that Vultureco is interested in.

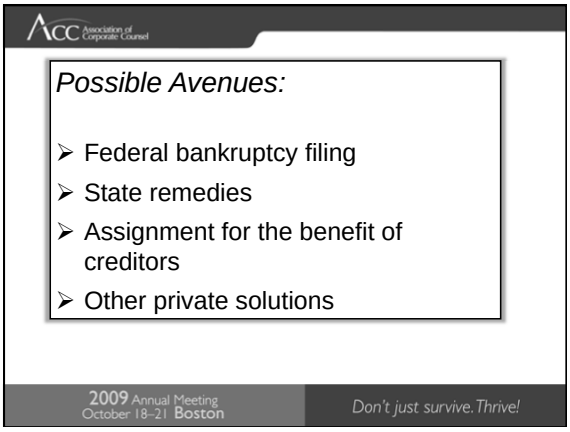
Question D1: The CEO asks you to draft a confidential agreement between the two companies to coordinate so they do not overlap. Any problems?

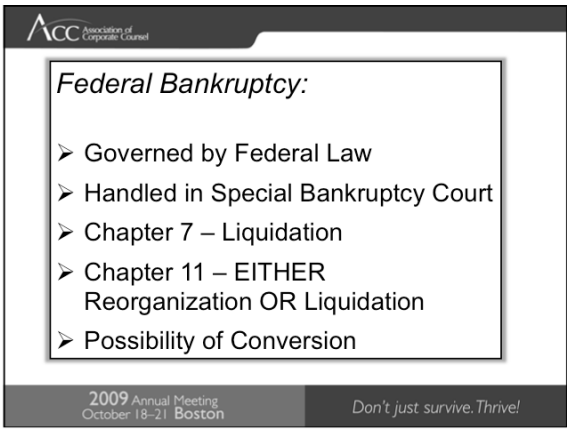
The CEO of Vultureco asks you questions relating to the automatic stay and its effects on collections efforts in Canada.

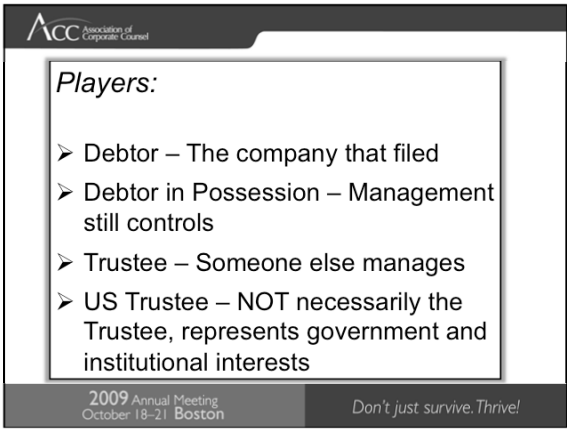
Question D2: At what point do you need to consult with specialty counsel with respect to hypothetical bankruptcy questions?

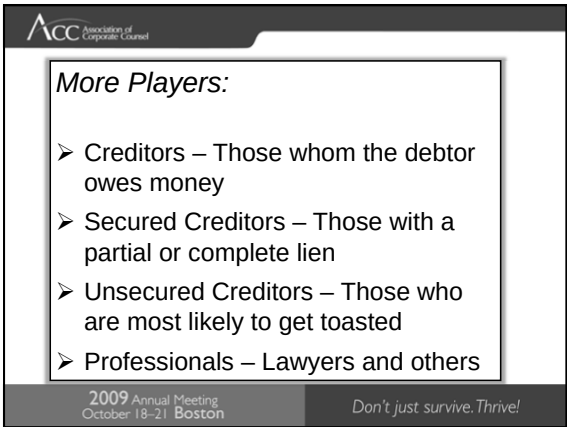


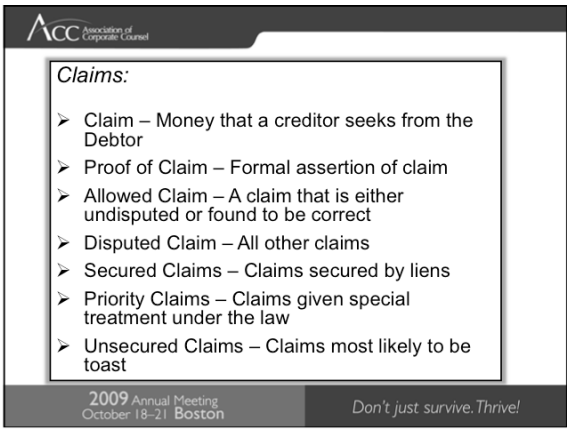


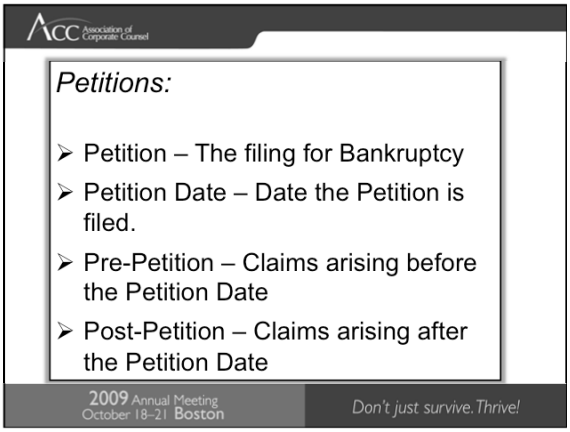


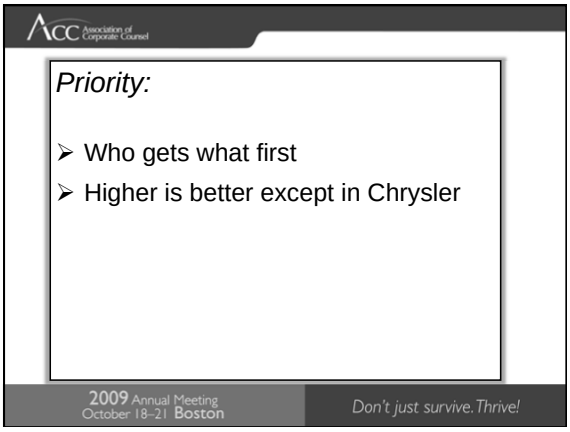


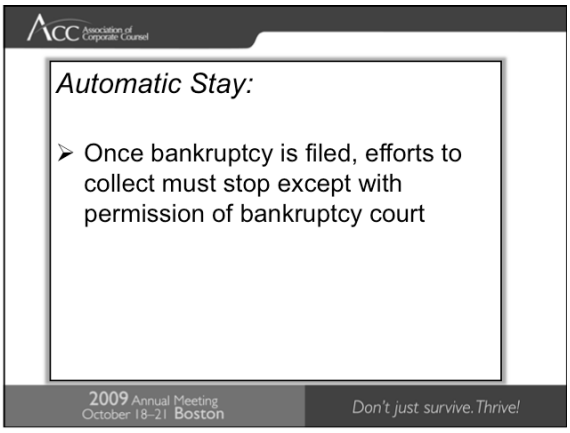


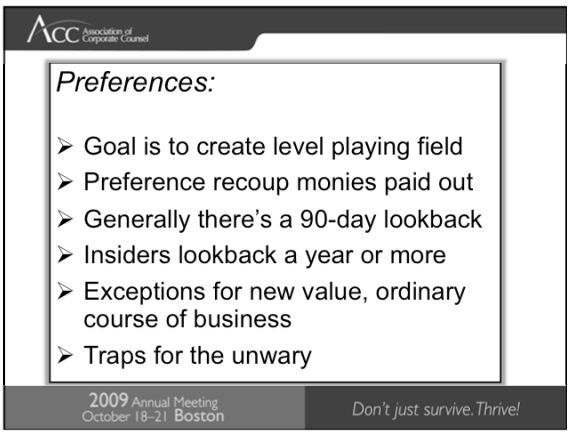


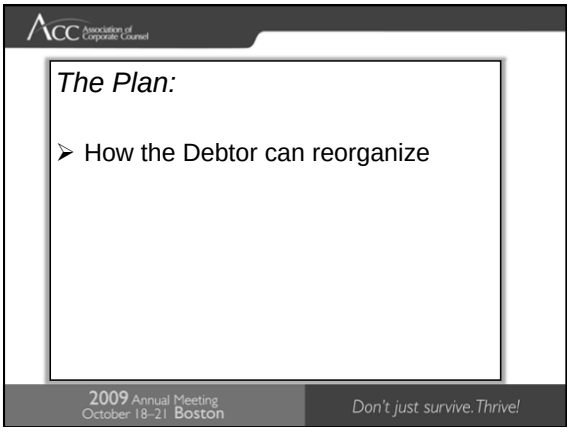












Discharge:

- What happens to the balance of claims at the end of bankruptcy
- They are gone

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The Debtor's Perspective

Monica Palko
BearingPoint, Inc. (former)

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Practical Issues For the Debtor:

- Litigation
- Investigations
- Records

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Litigation

- "Automatic" stay
- Litigation itself is not a "claim"
- Legal fees

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Investigations - Unique Stay Issues

- Claims against executives or other individuals
- Government investigations
- Litigation posture

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Records Management

- Rapid progress encouraged
- Departing employees
- Secrecy often valued
- Cost
- Does not improve with age

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Whose documents are they, anyway?

- Asset versus entity sale
- Core documents versus work product
- Employee loyalty shifts
- Outside versus internal guidance
- International considerations

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Insurance

- Last one standing
- D&O policy
- Plaintiff's inquiry
- Individual's inquiry
- Any obligation to ask or advise of records status

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The Creditor's Perspective

Karen Frame
Market Force Information, Inc.

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Practical Issues for the Creditor:

- Yikes, Customer is $500K behind in payments and just filed for bankruptcy protection – what do we do?
- Follow the Filing, read the documents
- Chapter 7 or 11
- Think ahead, think creatively

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Think Ahead, Think Creatively

- Pre-petition
  - Language in agreement (what are you selling – service or product)
  - Stop service if over 45 days late?
  - Purchase money security interests/liens until paid in full (how to avoid Section 363 sales)
  - Consignments
  - Letters of credit & guarantees
  - Trade credit insurance
- Post-petition – restructure agreement, new agreement?

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Think Ahead, Think Creatively

- Judgments in state and federal court
- Pre-judgment attachments, garnishments, executions, Debtor's examinations, & other proceedings
- Reclamation rights, setoff rights, rights of recoupment, lien enforcement, assignments for the benefit of creditors & the commencement of involuntary bankruptcy proceedings
- Representation at bankruptcy

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Think Ahead, Think Creatively

- Avoiding fraudulent transfers, post-petition transfers, lien avoidance actions, claims litigation,& preferences
- Selling claims to third parties – cutting your losses (who, how, why, & the documents associated with transferring claims)

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Resources:

- Bankruptcy Litigation Manual (American Bankruptcy Institute)
- ABI Preference Handbook (ABI)

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To the Lifeboats[1]

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[1] The views expressed herein are solely those of the authors and do not necessarily represent the opinions or beliefs of AVX Corporation or Mintz Levin Cohn Ferris Glovsky and Popeo, PC. This presentation does not constitute legal advice and may not address all issues surrounding a particular individual's or business's circumstances.

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Ethical Considerations for In-House Counsel to the Debtor in Possession

Introduction and General Principals

All lawyers are subject to ethics rules that guide and govern a lawyer's responsibilities to its current clients, former clients, the tribunal, federal or state agencies. These ethics rules apply equally to in-house counsel. Compliance with such ethics may often be more arduous for in-house counsel because provisions requiring or allowing withdrawal from representation or requiring or permitting disclosure of a client's wrongdoing create a much higher stakes decision for in-house lawyers since withdrawal from representing a client/employer usually means termination of employment. These already complex ethics rules become exacerbated in an insolvency situation where a corporation's fiduciary duties shift to include its creditors and where the day-to-day facts and circumstances may be constantly shifting.

A. Source of Ethics Rules

State of Licensure. A lawyer must first look to the ethics rules adopted by the state in which he or she is licensed. Generally, the highest court in each state promulgates the ethics rules, and either the state bar association or the state's highest court administers the disciplinary system based on those rules. The majority of states have adopted a variation of the ABA Model Rules of Professional Conduct (the "Model Rules"). Those states that have adopted a variation of the Model Rules, have largely followed the Model Rules provisions relating to conflicts of interest. However, states have varied from the Model Rules on matters involving confidentiality. For example, the Model Rules do not require a lawyer to disclose their client's intended future wrongdoing, and have permitted such a disclosure only in very limited circumstances (e.g., to prevent death, serious bodily harm or serious financial loss), however, many states' ethics rules provide that a lawyer may disclose a client's intended future wrongdoing and a minority of states *require* a lawyer to disclose their client's intended future wrongdoing in certain circumstances.[4]

Rules of Tribunal. Lawyers appearing before a tribunal must also be aware of and comply with the ethics rules of the tribunal. For bankruptcy matters, title 11 of the United States Code (the "Bankruptcy Code") and the Federal Rules of Bankruptcy Procedure include specific ethics rules relating to retention of professionals that are paid by assets of the estate. See Baker v. Humphrey, 101 U.S. 494, 502 (1879) (lawyers are both officers of the law and agents of their clients); see also In re Rivers, 167 B.R. 288, 301 (Bankr. N.D. Ga. 1994) (holding that the debtor in possession's attorney has duties that extend beyond the debtor to the court and the debtor's bankruptcy estate, and if the interests of the court or the estate conflict with the interests of the debtor, the court and

[4] See Virginia Rule 1.6(c)(i). Virginia is in the minority in requiring a lawyer to "promptly reveal" a client's intent to commit a crime, however slight, which crime is stated by the client and the client chooses not to abandon the criminal scheme after consultation with the lawyer.

estate interests control). In addition, local rules of the tribunal should be consulted to be sure to comply with any parochial ethics rules.

Secondary Source Guidance
The Restatement (Third) of Law Governing Lawyers is a further source of guidance for lawyers in analyzing their ethical duties.

B. Relevant Model Rules.

Client-Lawyer Relationship
Rule 1.2 Scope of Representation And Allocation of Authority Between Client And Lawyer

(a) Subject to paragraphs (c) and (d), a lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued. A lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation. A lawyer shall abide by a client's decision whether to settle a matter. In a criminal case, the lawyer shall abide by the client's decision, after consultation with the lawyer, as to a plea to be entered, whether to waive jury trial and whether the client will testify.

(b) A lawyer's representation of a client, including representation by appointment, does not constitute an endorsement of the client's political, economic, social or moral views or activities.

(c) A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.

(d) A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

Rule 1.6: Confidentiality of Information

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to prevent reasonably certain death or substantial bodily harm;

(2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

(3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

(4) to secure legal advice about the lawyer's compliance with these Rules;

(5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or

(6) to comply with other law or a court order.

Rule 1.13 Organization as Client

(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 that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.

(c) Except as provided in paragraph (d), if

(1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

(d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

(e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.

(f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

(g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

The comment to Rule 1.13 23 provides additional explanation to the basic provisions of the rule and adds the following important points:

(1) Rule 1.13 does not limit or expand the lawyer's responsibility under Rules 1.2, 1.6, 1.8, 1.16, 3.3, and 4.1; 24 and

(2) Rule 1.13 allows a corporate lawyer to represent the directors and officers in a shareholder's derivative lawsuit on behalf of the corporation if the derivative action is a "normal incident of the organization's affairs" absent "serious charges of wrongdoing" on behalf of the directors or officers.

(3) There are no comments that speak directly to the dual-status of the attorney-employee of an organizational client.

C. In-House Counsel to the Debtor

Serving as in-house counsel to a company contemplating a bankruptcy or in bankruptcy is not for the faint of heart. There are numerous potential ethical landmines that will need to be navigated on a daily basis. In Scenario A to these materials, in-house counsel is faced with several potential issues. In evaluating issues raised in Scenario A, in-house counsel should consider the following questions.

- **Whom do you represent?**

The in-house lawyer’s client is its employer. Model Rule 1.13(a) provides that a “lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.” For a lawyer employed by a corporation, the corporation is his or her client and the lawyer does not represent any individual officer or member of the board of directors. This seemingly simple fact often presents the most potential for a high-wire act for the in-house lawyer and its client. The in-house lawyer may frequently be asked to advise the officers and directors concerning a course of action that may be beneficial to the corporation but may cause liability to the very directors and officers that have sought the lawyer’s counsel.

Under Model Rule 1.6, an in-house counsel has a duty to maintain confidentiality in all information relating to the representation of his or her client. This rule is aimed at

promoting the free flow of information and open communication which are essential for in-house counsel in carry out his or her duties. However, if the in-house counsel "knows that an officer, employee or 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 that might be imputed to organization... that lawyer shall proceed as reasonably necessary in best interest of the organization." Model Rule 1.13. Furthermore, Model Rule 1.13 states that when there is a "violation of legal obligation to the organization" or a "violation of law which reasonably might be imputed to the organization" the attorney must take action.

Model Rule 1.13(b) therefore sets out the steps an attorney must take when contemplating whistle-blowing. In Scenario A, the president of the company has spoken to counsel in private. Suppose that in addition to discussing the attorney-client privilege and in connection with approving certain accounts payable, the president inquires about the potential claims and damages the president may suffer if the company does not pay his personal credit card bill, which was used for a business conference. In-house counsel is convinced that if he advises the president that the president will incur personal liability for the credit card debt solely in the president's name, then the president will direct immediate payment of the credit card bill and defer payments on other trade creditors. In addition, in-house counsel aware of the sizeable bonus paid to the president approximately 10 months ago.

During this conversation, the in-house counsel should first make it clear to the CFO that the lawyer represents the corporation and not the president. The lawyer should advise the president to seek independent counsel. The lawyer, as representative of the corporation must next make a determination whether (a) a two (2) month delay in filing for bankruptcy, and (b) payment of the president's credit card invoice would cause substantial injury to the organization. If so, then under Rule 1.13, the lawyer must proceed in the best interest of the company and shall report the matter "up the corporate ladder" until the lawyer reaches the board of directors. If, after counseling the Board, the lawyer continues to believe that the violation is reasonably certain to result in substantial injury to the company, the in-house counsel may have to resign.

Under these procedures, the in-house counsel must possess actual knowledge of wrongdoing. Even if the president did not inform the in-house lawyer of the bonus payment or intent to convert monies for payment of his credit card bill, Model Rule 1.13 provides that if such knowledge can be inferred from circumstances, the attorney cannot ignore any obvious violations. However, although corporate information may be revealed by the in-house counsel in certain situations as prescribed by Model Rule 1.13(c), disclosure is only an option, not a requirement.

- **Do your duties change as the company gets closer to insolvency?**

The duties of counsel to a financially troubled company will be dependent upon the corporation's duties to its stakeholders. Prior to a corporation's insolvency and to the

consternation of creditors, the courts have continually held that an officer and director's loyalties are to shareholders and not creditors. See Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 273 (2d Cir. 1986)); Alpert v, 28 Williams St. Corp, 63 N.Y.2d 557, 561 (N.Y. 1984) (noting that under New York law directors "have an obligation to all shareholders to adhere to fiduciary standards of conduct and to exercise their responsibilities in good faith when undertaking any corporate action"); Schwartz v. Marien, 37 N.Y.2d 487, 491 (N.Y. 1975) ("[M]embers of a corporate board of directors . . . owe a fiduciary responsibility to the shareholders in general . . . ."); Pittelman v. Pearce, 8 Cal. Rptr. 2d 359 (1992); C-T of Virginia, Inc. v. Barrett, 124 B.R. 689, 692-693 (W.D. Va. 1990) (holding that directors owed no fiduciary duties to creditors in connection with leveraged buyout since once directors "determined that the best way to serve shareholder interests was to place the firm on the market, . . . the directors' duties were limited . . . to gain[ing] the highest price for its shareholders. [This] duty cannot extend to the interests of current or future unsecured creditors of the company.").

When a corporation is insolvent, however, the corporation owes a fiduciary duty to its creditors, in addition to its shareholders. Generally, this obligation is defined primarily by the "trust fund doctrine." See Credit Agricole Indosuez v. Rossiyskiy Kredit Bank, 94 N.Y.2d 541, 549 (N.Y. 2000). Specifically, "officers and directors of an insolvent corporation are said to hold the remaining corporate assets in trust for the benefit of its general creditors." Id.; see also Clarkson Co. Ltd. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981).

A more complex issue involves whether a corporation owes a fiduciary duty to its creditors if the corporation is in the “zone of insolvency” and, if so, whether creditors may bring claims of breach of such duty. Although, the Delaware courts have not defined the oft-used phrase “zone of insolvency,” this has been an area of active litigation. These materials provide only a brief review of these issues. For a more in-depth analysis of the potential liabilities to a corporation, the zone of insolvency, see Hamer, Michelle M. and Brighton, Jo Ann J., *The Implications of North American Catholic and Trenwick: Final Death Knell for Deepening Insolvency? Shift in Directors' Duties in the Zone of Insolvency?*, 2007 Norton Annual Survey of Bankruptcy Law, Thomson West (January 2008). As an area of unsettled law, a close analysis of the choice of law and the facts and circumstances of the given matter are essential prior to advising a board regarding its obligation during the zone of insolvency.

In an important decision from the Delaware Supreme Court, the court held that creditors of a Delaware corporation in the "zone of insolvency" may not assert *direct* claims for breach of fiduciary duty against the corporation's directors. See N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 94 (Del. 2007). The court in Gheewalla stated in dicta that a creditor of an insolvent corporation has standing to assert a derivative claim for breach of fiduciary duty. Id. at 101. However, Gheewalla did not opine whether a creditor may pursue a *derivative* claim if the corporation was in the “zone of insolvency.”

In a recent District Court decision from the Southern District of New York, the court rejected the plaintiff's argument that it held a cause of action against the corporation's fiduciaries based on actions taken during the corporation's "zone of insolvency." RSL Communs. PLC v. Bildirici, 2009 U.S. Dist. LEXIS 72691 (S.D.N.Y. Aug. 10, 2009). The court reasoned that the "zone of insolvency" theory does not stand to reason. "The incantation of the . . . words zone of insolvency should not declare open season on corporate fiduciaries." Id. (citing Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 174 (Del. Ch. 2006)).

Although the recent case law from New York and Delaware suggests that the trend is moving away from recognizing a creditor's standing to bring a direct or derivative suit against a company while in the "zone of insolvency," much relevant case law continues to provide that a corporation owes an expanded fiduciary duty to include creditors when the corporation is in the zone of insolvency. See Mims v. Fail, 2007 Bankr. LEXIS 3240, *10-12 (Bankr. N.D. Tex. Sept. 18, 2007) (explaining that Gheewalla clarified that, under Delaware law, creditors of a corporation that is either insolvent or in the "zone of insolvency" can maintain derivative suits for breach of fiduciary duty against corporate directors). Officers and directors that are aware that the corporation is insolvent, or within the "zone of insolvency" may have expanded fiduciary duties to include the creditors of the corporation. See Floyd v. Hefner, 2006 U.S. Dist. LEXIS 70922 (S.D. Tex. Sept. 29, 2006); see also Weaver v. Kellogg, 216 B.R. 563, 583-84 (S.D. Tex. 1997).

Because the law is not fully settled on the rights of creditors to pursue claims against directors and officers for breach of their fiduciary duties while in the zone of insolvency, it is prudent counsel to the corporation to consider its creditors and to expand its fiduciary duties to include the creditors if there is any doubt as to the corporation's solvency. It is often only in hindsight during significant litigation that a corporation is determined to be solvent or insolvent at a specific point in time and it may be far too risky to ignore the interests of creditors while the corporation is in a zone of insolvency.

- **After filing, who is your client?**

When a corporation files for chapter 11 bankruptcy, it becomes a debtor in possession See 11U.S.C. § 1101. As a debtor in possession, the actions taken by the corporation must be for the benefit of the *entire* estate and not simply the corporation's shareholders. The United States Supreme Court ruled in Commodity Futures Trading Commission v. Weintraub, that "the willingness of courts to leave debtors in possession 'is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee.'" See Commodity Futures Trading Commission v. Weintraub, 471 U.S. 343 at 358 (1985).

- **What happens to the privilege?**

The issue in Weintraub was whether a bankruptcy trustee has power to waive the debtor corporation's attorney-client privilege with respect to pre-petition communications. Commodity Futures Trading Com v. Weintraub, 471 U.S. 343 at 349 (U.S. 1985). (“when control of a corporation passes to new management, the authority to assert and waive the corporation's attorney-client privilege passes as well"). Weintraub is instructive on the shift of corporate allegiance upon entering bankruptcy. “[B]ankruptcy causes fundamental changes in the nature of corporate relationships. 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.” Id. at 355.

Because management of a solvent corporation controls its privilege, the Supreme Court looked to "the roles played by the various actors of a corporation in bankruptcy to determine which is most analogous to the role played by the management of a solvent corporation." Id. at 351. The Court concluded that the trustee controls the privilege in the bankruptcy of a corporate debtor.

Under Scenario A, the company’s president has asked to have a confidential conversation with in-house counsel prior to the bankruptcy. The conversation, however, may not remain confidential. First, because a corporation acts through its authorized officers, the president should be aware that regardless of any bankruptcy proceeding, it is the corporation’s privilege that may be waived and the privilege is not held by the individual officer. If the president is terminated, he may not prevent the corporation from waiving the privilege with respect to any conversation with the president. The potential difference in a bankruptcy case is that the trustee is an unrelated third-party to the company and is most often appointed to liquidate a corporation and, therefore, may not have the same objectives of preserving the privilege as enjoyed by the company’s prior management. A company contemplating bankruptcy must be aware that upon entering bankruptcy, the debtor in possession controls the privilege for the benefit of its stakeholders. If a case converts from one under chapter 11 to one under chapter 7, the privilege passes to the chapter 7 trustee, who has the ultimate right to waive the attorney-client privilege.

- **What if the Board does not meet its fiduciary duty?**

The decisions of the directors of a corporation generally be reviewed under the business judgment rule. The Supreme Court of Delaware has determined that a directors’ decisions will be respected by courts unless directors are (1) interested or lack independence relative to the decision, (2) do not act in good faith, (3) act in a manner that cannot be attributed to a rational business purpose or (4) reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available. Brehn v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000). A board that does not meet its fiduciary duties may subject the board members and the corporation to the

following claims: breach of fiduciary duty; aiding/abetting breach of fiduciary duty; declaration/payment of unlawful dividend; fraudulent conveyance; and breach of contract.

Independent of potential claims against the Board, the in-house lawyer may be liable for direct claims for breach of fiduciary duty. In any representation, a lawyer is a fiduciary of the client. See, e.g, SMWNPF Holdings, Inc.v. Devore, 165 F.3d 360, 365 (5th Cir. 1999) (recognizing that the attorney is the client's fiduciary); see also Roy Ryden Anderson & Walter W. Steele, Jr., *Fiduciary Duty, Tort and Contract: A Primer on the Legal Malpractice Puzzle*, 47 SMU L. Rev. 235, 240 (1994) (an attorney owes a duty of loyalty and care to its client and may be personally liable for any derogation of such duties). As such, a lawyer owes the client a duty to act in the client's best interests. Any time a lawyer takes a course of action that is not designed with the client's best interests at heart, the lawyer exposes him or herself to liability on the basis of breach of that duty. Courts have held that, as part of this fiduciary duty, a lawyer must make inquiries and take action to educate the client of the client's own duties in the bankruptcy case. See In re Rusty Jones, Inc., 134 Bankr. 321, (Bankr. N.D. Ill., 1991); see also In re Wilde Horse Enters., Inc., 136 B.R. 830, 840 (Bankr. D. Cal. 1991) (as a fiduciary of the estate, the debtor's lawyer must remind the debtor of the debtor's duties under the Bankruptcy Code).

- **What if you know of preferences or a fraudulent transfers?**

In-house counsel to the debtor in possession must be particularly aware of not only their obligations under the Model Rules, but of the potential ethical challenges imposed as a result of the bankruptcy. A preference under the bankruptcy code is a payment to or for the benefit of a creditor made while the debtor was insolvent within the 90 days prior to the bankruptcy (or one year for insiders, which includes the officers of the debtor) and that such payment enabled the creditor to receive more than it would receive under a liquidation in chapter 7. 11 U.S.C. § 547. A fraudulent transfer may be either an actual fraudulent transfer or a constructive fraudulent transfer, governed by both state law and federal bankruptcy law. 11 U.S.C. §§ 544 and 548. An actual fraudulent transfer requires evidence that the transfer was made with actual intent to hinder, delay or defraud creditors. See 11 U.S.C.§ 548(a)(1)(A). A constructive fraudulent transfer does not involve the element of intent and is a transfer for which the debtor received less than reasonably equivalent value in exchange for such transfer. See 11 U.S.C.§ 548(a)(1)(B). Avoidance actions, including preferences and fraudulent transfer claims, promote the overall goal of bankruptcy. With limited exception, the Bankruptcy Code is premised on equality of treatment to similarly situated creditors and that a lower class of creditors shall receive a distribution only after a senior class of creditors is satisfied in full.

Counsel to the debtor in possession owes its allegiance to the bankruptcy estate and not to the principals of the estate. In re Grabill Corp., 113 B.R. 966 (Bankr. N.D. Ill. 1990) (noting counsel for corporation owes duty to corporation and not principals). In particular, counsel to the debtor in possession can not place his or her head in a hole in the sand to avoid matters having legal consequences to the estate, which includes

investigating potential causes of action and recoveries to the estate such as preference and fraudulent transfer actions. In addition, where counsel has assisted a client in making a fraudulent transfer, counsel was found personally liable. See Stochastic Decisions, Inc. v. DiDomenico, 995 F.2d 1158 (2d Cir. 1993) (an attorney was held liable to third party creditors for assisting a client in making a fraudulent conveyance). See also Prudential Ins. Co. v. Dewey, Ballantine, Bushby, Palmer & Wood, 605 N.E.2d 318 (N.Y. 1992); Collins v. Binkley, 750 S.W.2d 737 (Tenn. 1988).

In Scenario A, the company has been losing money for years and is arguably insolvent. In-house counsel believes that the president is advocating that the board delay authorizing a bankruptcy filing because of a significant bonus the president received ten (10) months prior. In-house counsel knows that if the filing is delayed for two additional months then the president will not be subject to a preference claim. Although a company is not required to file for bankruptcy, as an insolvent enterprise, it owes a fiduciary duty to both its shareholders and its creditors. If the company is taking actions *solely* for the benefit of an insider that results in a direct and substantial harm to its stakeholders (i.e. depriving the estate of a material and substantial preference claim recovery), then the board is exposing itself to a potential breach of fiduciary duty challenge. Further, under Model Rule 1.13, in-house counsel has an obligation to raise this issue with the board.

The decision of a public company to file for bankruptcy, however, is rarely premised on one potential preferential transfer. Many determining factors will be considered as a company evaluates its options. Importantly, the company must be informed of all relevant facts as it considers appropriate alternatives for the stakeholders. It is this thoughtful consideration of options at the heart of the corporation's business judgment.

- **What are the consequences of violating ethics rules before the Bankruptcy Court?**

The majority of existing case law evaluating ethics in bankruptcy involve outside bankruptcy counsel, rather than in-house counsel. The primary tool in policing ethics in bankruptcy is disgorgement of professional fees and sanctions. Because in-house counsel is paid directly by the debtor as an employee, these materials will not discuss issues involving counsel retention and disgorgement of fees. However, because in-house counsel to the debtor has the same fiduciary duties to the debtor in possession as the outside bankruptcy counsel, the following cases are instructive for in-house counsel in their relationship with their debtor client in bankruptcy.

Civil Penalties:

(a) Disbarment:

- Courts have disbarred attorneys for the debtor where the attorneys knowingly concealed clients' property on the eve of bankruptcy. See, e.g., In re Appel, 62 A.2d 442 (N.Y. 1978); In re Pfingst, 53 A.D.2d 268 (N.Y. App. Div. 1976); People v. Schwarz, 814 P.2d 793 (Colo. 1991).

- Some courts have also held that the bankruptcy court has authority to suspend or disbar attorneys as a sanction for contempt. See In re Assaf, 119 B.R. at 467 (holding that the bankruptcy court had the power to enter suspension order pursuant to civil contempt authority) (citing D.H. Overmyer Co, Inc. v. Robson, 750 F.2d 31 (6th Cir. 1984); In re Pearson, 108 Bank. 804 (Bank. S.D. Fla. 1989); In re Heard, 106 Bank. 481 (Bank. N.D. Ohio 1989); In re Nesom, 76 Bank. 101 (Bank. N.D. Texas 1987); In re Derryberry, 72 Bank. 874 (Bank. N.D. Ohio 1987); In re Printree, Ltd., 40 Bank. 131 (Banks. S.D.N.Y. 1984).

(b) Sanctions/Civil Contempt

- Federal Rule of Civil Procedure 11(b) and Bankruptcy Rule 9011 provide that the attorney submitting a pleading, written motion, or other paper to the court, the attorney is certifying that to the best of the attorney's knowledge, information and belief, the submission is not for an improper purpose, the claims presented are warranted by existing law and are otherwise not frivolous and there is factual support for allegations presented and any denials of factual contentions are warranted by the evidence or are otherwise based on a lack of information and belief. A violation of Rule 9011 may result in sanctions by the court, either upon a motion or on the court's own initiative. See, e.g., Morley v. Ciba-Geigy, 66 F.3d 21, 24 (2nd Cir. 1995).

- The Bankruptcy Court possesses the power to discipline attorneys that appear before them for misconduct. In re Assaf, 119 B.R. 465, 467 (Bank. E.D. Pa. 1990) (cases cited) (bankruptcy court may "use civil contempt to enforce its orders and to disciple attorneys before it"); See also In re Sheridan, 362 F.3d 96 (1st Cir. 2004); In re Johnson, 921 F.2d 585, 586 (5th Cir. 1991); In re Marvel, 265 B.R. 605 (N.D. Cal. 2001) (citing In re Rainbow Magazine, 77 F.3d 278 (9th Cir. 1996).

Bankruptcy Crimes:

In addition to civil disbarment, in-house counsel should be aware of the following criminal offenses:

(a) Concealment of assets; false oaths and claims; bribery, 18 U.S.C. § 152

- It is a criminal offense to:
  - "knowingly and fraudulently" conceal assets belonging to the estate of the debtor in relation to cases and proceedings under title 11.
  - make false statements under oath, file false claims, destroy or conceal financial records, and give or take bribes.

- A violation of this section is punishable by a fine and/or imprisonment for not more than five years. See, e.g., United States v. Rogers, 722 F.2d 557, 559 (9th Cir. 1983) (transferring assets on the eve of bankruptcy was violation of 18 U.S.C. § 152); United States v. Gellene, 182 F.3d 578 (7th Cir. 1999).

(b) Embezzlement against estate - 18 U.S.C. §153

- It is a criminal offense to:
  - embezzle property and hide or destroy any document belonging to the estate of the debtor. This law covers property of the estate and specifically covers employees and agents of those who have this access.
- A violation of this section provides fines and/or imprisonment for not more than 5 years. See e.g., Meagher v. United States, 36 F.2d 156 (9th Cir. 1929).

(c) Adverse interest and conduct of officers - 18 U.S.C. § 154

- It is a criminal offense for a custodian, trustee, marshal, or other officer of the court of a bankruptcy estate to *knowingly*:
  - purchasing property of that bankruptcy estate,
  - refuse to permit a party in interest a reasonable opportunity to inspect the books and records relating to the bankruptcy estate after being ordered to do so by the court, and
  - refuse to permit a United State Trustee a reasonable opportunity to inspect the books and records relating to the bankruptcy estate.
- A violation of this section is punishable by a fine and removal from office.

(d) Bankruptcy fraud - 18 U.S.C. §157

- It is a crime to devise or intend to devise a scheme or artifice to defraud and, for purposes of executing or concealing the scheme either
  - filing a bankruptcy petition;
  - filing a document in a bankruptcy proceeding; or
  - making a false statement, claim, or promise
    - in relation to a bankruptcy proceeding either before or after the filing of the petition; or
    - in relation to a proceeding falsely asserted to be pending under the Bankruptcy Code.
- A violation of this section is punishable by a fine and/or imprisonment for not more than 5 years.

(e) Destruction, alteration, or falsification of records in Federal investigations and bankruptcy - 18 U.S.C. § 1519

- Section 802 of the Sarbanes-Oxley Act of 2002 added a new criminal provision, 18 U.S.C. § 1519, which expands existing law to cover, among other things, the alteration, destruction or falsification of records, documents or tangible objects, by any person, with intent to impede,

obstruct or influence, the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States, or any case filed under title 11, or in relation to or contemplation of any such matter or proceeding.

- A violation of this section is punishable by a fine and/or imprisonment for not more than 20 years.

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Webcast. August 2009
http://www.acc.com/education/webcasts/canadianinsolvencylaw.cfm

Law Firms Uncertain on 2009, Four Trends that Can Transform Biglaw and Structuring the Lehman Bankruptcy.
Article. December 2008
http://www.acc.com/aboutacc/newsroom/accinthenews/law-firm-leaders-uncertain-on-2009.cfm

Bankruptcy Basics.
Program Material. May 2002
http://www.acc.com/legalresources/resource.cfm?show=144393

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