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DIP Counsel: Identifying the Client and Your Obligations Might Be Harder Than You Think

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Chapter 11 involves the interplay among several constituent groups, each with diverse interests. Consequently, debtor-in-possession (DIP) counsel faces a constantly changing field of alliances as interests converge and diverge.[1] Due to these ever-changing alliances and interests, there is a heightened risk for conflicts of interest, both real and potential. As a result, it is important for counsel to know whose interests they represent, what obligations they are undertaking, and when those obligations come to an end. DIP counsel faces an especially difficult task answering these questions, as courts and scholars have failed to reach a consensus regarding the existence and scope of a fiduciary duty to the estate, and when those obligations are satisfied.

The DIP, the Estate and DIP Counsel

In an ordinary chapter 11 case (if there is such a thing), the process of becoming DIP counsel is fairly straightforward. First, the proposed DIP counsel must determine whether he/she meets the requirements of § 327 of the Bankruptcy Code: holds no interest adverse to the estate and is a "disinterested" person. The Code does not define what constitutes an adverse interest, but it generally precludes representing any creditor or equity-holder of the estate and excludes those with a claim against the estate.[2] "Disinterested" is defined by § 101(14) and requires that DIP counsel not hold "an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders."

In addition to the requirements of § 327, the debtor must file an application to employ DIP counsel under Rule 2014, including a verified statement of *all* connections that the proposed DIP counsel has with the debtor, creditors and other parties in interest.[3] If all goes according to plan, the application to employ DIP counsel will be approved. Congratulations, you now represent the DIP — and possibly the estate.

What It Means to Represent the Estate

The commencement of a bankruptcy case creates the estate, and § 1107(a) makes the DIP a "trustee" for the estate.[4] The DIP is vested with the rights and powers of a trustee, but is also burdened with the responsibilities of a trustee under §§ 704 and 1106. Beyond the requirements of §§ 704 and 1106, courts have held that DIPs "and those who control them owe fiduciary duties to the bankruptcy estate."[5]

In addition to the DIP itself, many courts have held that DIP counsel, in its own capacity, owes fiduciary duties to the estate that are separate and independent from the DIP.[6] Many courts and scholars have examined the existence and scope of DIP counsel's duties to the estate,[7] but no consensus has

1 This is also one of the beautiful things about the U.S. Bankruptcy Code.

2 In order to avoid being a creditor of the estate, pre-petition counsel will need to make sure that the debtor has paid all invoices and that it is not indebted to counsel. *See* 11 U.S.C. § 1107(b).

3 The duty of disclosure continues throughout the case. *See In re West Delta Oil Co. Inc.*, 432 F.3d 347, 355 (5th Cir. 2005).

4 The estate is defined by § 541 to include "all legal or equitable interests of the debtor in property," a definition that has been broadly construed. *See, e.g., The Majestic Star Casino LLC v. Barden Dev. Inc. (In re The Majestic Star Casino LLC, et al.)*, 716 F.3d 736, 750 (3d Cir. 2013).

5 *In re Brook Valley VII, Joint Venture*, 496 F.3d 892, 900 (8th Cir. 2007); *see also Brown v. Gerdes*, 321 U.S. 178, 64 S. Ct. 487 (1944).

6 The court in *ICM Notes Ltd. v. Andrews & Kurth LLP* provides a thorough analysis of the competing views on the existence of a fiduciary duty owed by DIP counsel to the estate, but does not provide a definitive ruling on the issue and instead holds that DIP counsel does not owe a fiduciary duty to individual creditors. *See* 278 B.R. 117 (S.D. Tex. 2002).

7 *Compare Hansen, Jones & Leta PC v. Segal*, 220 B.R. 434 (D. Utah 1998), and Susan M. Freeman, "Are DIP and Committee Counsel Fiduciaries for Their Clients' Constituents or the Bankruptcy Estate? What Is a Fiduciary, Anyway?," 17 *Amer. Bankr. Inst. L. Rev.* 291 (Winter 2009), *with Hilal v. Williams (In re Hilal)*, 534 F.3d 498 (5th Cir. 2008), and C.R. "Chip" Bowles, Jr. and Prof. Nancy B. Rapoport, "Debtor Counsel's Fiduciary Duty: Is There a Duty to Rat in Chapter 11?," *ABI Journal* Vol. XXIX, 1, 16, 64-65, February 2010.

been reached, even among courts in the same district.[8] Less certain still is when such obligations come into effect and when they end. Because the Bankruptcy Code and case law both fail to provide sufficient guidance on these issues, we must look to the origins of the obligations and the nature of the obligations themselves to determine when DIP counsel's fiduciary duties to the estate begin and end.

Sources of Obligations to the Estate

The *Taxman* case was one of the first opinions to recognize a fiduciary duty between DIP counsel and the estate.[9] In that case, the court held that counsel for a chapter 11 trustee was a fiduciary of the estate based on his shared obligations with the trustee to endeavor "to maximize the value of the estate"[10] — a duty arising out of §§ 704 and 1006. Following the logic of *Taxman* and its progeny, courts have determined that duties owed by DIP counsel to the estate generally arise from two sources: the DIP's obligations to the estate under §§ 704 and 1006, and obligations as an officer of the court.[11] Those include the duty to (1) "carefully monitor each case and encourage conversion or dismissal without delay when it becomes apparent that reorganization is no longer feasible or that wrongdoing is taking place"; (2) inform the bankruptcy court of a DIP's violation of its fiduciary duties to the estate and its creditors; (3) disclose the diversion of DIP funds; (4) maximize the estate; and (5) exercise independent professional judgment on behalf of the estate and to disclose any actual or potential conflicts of interest with the estate.[12] If DIP counsel's duties to the estate are derivative of the DIP's obligations under §§ 704 and 1006, it follows that those duties should be coterminous with the creation and termination of the DIP and the estate.

Duties from §§ 704 and 1006

As previously noted, the estate is created by the commencement of a case. Thus, the fiduciary duties of the DIP, and therefore DIP counsel cannot begin until the commencement of a chapter 11 case.[13] Although the Code does not provide a list, there are several circumstances in which the DIP or estate cease to exist. It is almost axiomatic that the DIP and estate must end when the case is dismissed. The DIP is not a separate legal entity that can survive on its own, but rather the pre-petition debtor bestowed with certain privileges and obligations under the Code.[14] If the case ceases to exist, so does the DIP. Similarly, because the estate is a vessel for the debtor's property, it ceases to exist once the property has been vested in the reorganized debtor under a confirmed plan.[15]

In other circumstances, the estate continues to exist, but the debtor no longer operates as a DIP. If a chapter 11 case is converted to chapter 7, the debtor loses the privilege of operating as a DIP and consequently loses its fiduciary obligations to the estate. Likewise, the appointment of a chapter 11 trustee vests the fiduciary duties of §§ 704 and 1006 with the trustee and the debtor no longer operates as a DIP. Accordingly, if DIP counsel owes fiduciary duties to the estate that are derivative of the DIP's obligations, those duties should end upon (1) dismissal of the case, (2) plan confirmation, (3) conversion of the case or (4) the appointment of a chapter 11 trustee.

This conclusion comports with the nature of the fiduciary obligations themselves. For example, the duty to "encourage conversion or dismissal without delay when it becomes apparent that reorganization is no longer feasible or that wrongdoing is taking place"[16] is resolved upon conversion or dismissal. Likewise, the duty to disclose the diversion of DIP funds and the duty to maximize the estate are resolved once the property of the estate is transferred to the reorganized debtor or to a chapter 7 or 11 trustee. Accordingly, the nature of DIP counsel's fiduciary duties to the estate that arise from §§ 704 and 1006 dictates that they extinguish once a case is converted or dismissed, a plan is confirmed or a chapter 11 trustee is appointed.

Duties as an Officer of the Court

In addition to obligations arising from §§ 704 and 1106, courts have determined that DIP counsel owes fiduciary duties to the estate arising from its obligations as an officer of the court. These cases typically involve misrepresentations in pleadings filed with the court (including the debtor's schedules), or unreasonable or inaccurate fee applications.[17] DIP counsel's obligations as an officer of the court, including the duty of candor, arise from common law and the rules of professional conduct, and are not subject to change based on the status of the case. As a result, such obligations continue beyond the conversion, dismissal, plan confirmation or the appointment of a trustee. For example, a fee application under § 330 might be filed well after a case has been converted, a trustee has been appointed or a plan has been confirmed. Therefore, DIP counsel's obligation of candor in incurring and seeking compensation for fees survives, and a violation thereof might result in a denial of fees for breach of fiduciary duties to the estate.[18] Accordingly, DIP counsel must look to the nature and source of their obligations to the estate to determine when their obligations to the estate end.

The Ethical Dilemma

Nothing in the Bankruptcy Code alleviates counsel's duties or responsibilities under state ethics laws, which may conflict with obligations that are owed to the estate. For example, suppose that you are DIP counsel for a corporation that is owned and controlled by a single individual who informs you that he has misappropriated corporate funds while operating as a DIP. This revelation may implicate several obligations to the estate: a duty to (1) encourage the conversion or dismissal because wrongdoing is taking place;

8 *Compare In re Specialty Rest. Grp. LLC*, No. 07-30779, 2007 WL 1231603 (Bankr. N.D. Tex. April 24, 2007), *with In re Marble*, No. 07-50099, 2007 WL 1556836 (Bankr. N.D. Tex. May 25, 2007).

9 *In re Taxman Clothing Co.*, 49 F.3d 310, 314-316 (7th Cir. 1995).

10 *Id.*

11 *See ICM Notes Ltd.*, 278 B.R. at 124.

12 *Id.* (internal citations omitted).

13 A chapter 7 case creates an estate, but that estate is managed by a chapter 7 trustee, and thus, there is no DIP or DIP counsel. *See* Clarissa M. Raney, "The Scope of Fiduciary Duties Owed by Chapter 7 Debtor's Counsel," *ABI Young & New Members Committee Newsletter*, Vol. 11, No. 4 ("[T]he estate is the responsibility of the chapter 7 trustee and not of the chapter 7 debtor or its counsel.").

14 *See N.L.R.B. v. Bildisco and Bildisco*, 465 U.S. 513, 528-29, 104 S. Ct. 1188 (1984).

15 *See* 11 U.S.C. § 1141(b). Since it is possible for assets to remain in the estate post-confirmation if the plan so provides, we can conclude that the fiduciary duties owed to the estate remain intact to the extent that the assets remain in the estate.

16 *See ICM Notes Ltd.*, 278 B.R. at 124.

17 *See, e.g., In the Matter of Evangeline Refining Co.*, 890 F.2d 1312, 1323, n.8 (5th Cir. 1989) ("The filing of a fraudulent fee application by a trustee or attorney for the trustee is a flagrant violation of the obligation of candor to the court and fiduciary obligations to the estate.... Such conduct is a violation of ethical obligations as well.").

18 *Id.*; *In re Taxman Clothing Co.*, 49 F.3d at 314.

(2) inform the bankruptcy court of the DIP's violation of its fiduciary duties to the estate and its creditors; and (3) disclose the diversion of DIP funds.[19] However, state ethics laws provide that an attorney may not reveal client confidences absent a crime or fraud in which the client has used or is using the lawyer's services.[20] Some ethics laws allow an attorney to reveal client confidences "to comply with other law."[21] However, this exception does not resolve the dilemma because courts (even those within single jurisdictions)[22] have not come to a consensus as to the obligations of DIP counsel, and thus, the requirements of the "other law" are uncertain. Therefore, the attorney is left with the burden of balancing his/her obligations to the estate (although it is not clearly defined) with his/her obligations to the debtor under state ethics laws.[23]

At a minimum, this scenario shows the tension between state ethical obligations and the duties of DIP counsel as a fiduciary of the estate. Moreover, misappropriation of DIP funds is likely the simplest scenario in which such an ethical dilemma will arise. There are innumerable other examples of conduct that is less atrocious, and therefore makes it more challenging to evaluate the balance between obligations to the estate and to the debtor.

Conclusion

The fiduciary obligations of DIP counsel to the estate are not well defined in extent or duration. As a result, DIP counsel should be mindful of the potential to be considered a fiduciary of the estate. While the debtor is subject to the obligations of §§ 704 and 1106 (before conversion, dismissal, plan confirmation or the appointment of a trustee), DIP counsel might be held to the same duties as the DIP. After conversion, dismissal, plan confirmation or the appointment of a trustee, DIP counsel might still be considered a fiduciary of the estate, but only to the extent of its general obligations as an officer of the court. abi

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19 *See ICM Notes Ltd.*, 278 B.R. at 124.

20 *See* Rule 1.6(2)-(3) Am. Bar Assoc., *Annotated Model Rules of Professional Conduct* (7th ed. 2011); Rule 1.05 of the Texas Disciplinary Rules of Professional Conduct.

21 *Id.* at Rule 1.6(6).

22 *See* n.8.

23 The Professional Ethics Committee for the State Bar of Texas has examined a similar scenario for an insolvent corporation outside of the bankruptcy context and determined that an attorney may only reveal client confidences if doing so would prevent an ongoing fraud; a breach of fiduciary duties to creditors is insufficient. *See* Texas Supreme Court Professional Committee, Ethics Opinion No. 603 (November 2010).