

# Duty of Lawyers Representing Insolvent Debtors to Disclose Confidential Information to Creditors

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An attorney representing a client in a chapter 11 debtor-in-possession case, especially if the client is closely held, can encounter significant ethical dilemmas stemming from conflicts between the personal interests of the client representative and that representative's fiduciary obligations to the client or its creditors.<sup>1</sup> The dilemma results from a lawyer's competing duty of confidentiality on one hand and the lawyer's duty of disclosure on the other hand in situations where management misconduct might constitute a fraud or crime, a dilemma that Maryland's highest court termed a "legal ethics nightmare."<sup>2</sup>



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The problem was recently considered by the Professional Ethics Committee for the State Bar of Texas in Ethics Opinion 603.<sup>3</sup> The committee addressed the obligation of an attorney representing an insolvent,

closely-held corporation to disclose, or not disclose, confidential information to the creditors of that corporation. The committee framed the specific question before it as follows:

Do the Texas Disciplinary Rules of Professional Conduct require or permit a lawyer to reveal to [an insolvent] corporation's creditors the lawyer's advice to the corporation that the person who owns and manages the corporation has engaged in conduct that consti-

<sup>1</sup> The scope of the duty owed by fiduciaries of an insolvent entity to that entity's creditors is not cut-and-dried. The law of the state under which the entity was chartered will typically control irrespective of the law of the forum state. Under both Texas and Delaware law, there is substantial authority that insolvency creates a fiduciary duty owed by management to creditors. *Carrieri v. Jobs.com Inc.*, 393 F.3d 508, 534 n. 24 (5th Cir. 2004); *Weaver v. Kellogg*, 216 B.R. 563, 584 (S.D. Tex. 1997). But see *Milbank v. Holmes (In re TOCFHBI Inc.)*, 413 B.R. 523, 539 (Bankr. N.D. Tex. 2009), in which the bankruptcy court clarified that under either Texas or Delaware law, no fiduciary duty is owed by the managers of an insolvent entity directly to creditors, but rather the duty is owed to the corporation.

<sup>2</sup> *Attorney Grievance Commission of Maryland v. Rohrback*, 591 A.2d 488, 489 (Md. 1991). Examples in the bankruptcy context concern management decisions pertaining to claims by and against insiders, such as management's refusal to pursue significant avoidance claims under 11 U.S.C. §§ 547 or 548.

<sup>3</sup> Tex. Comm. on Prof'l Ethics, Op. 603, 74 Tex. B. J. 74 (2010).

## About the Author

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tutes a breach of the person's fiduciary duties to the corporation?<sup>4</sup> This article discusses the committee's analysis, significant distinctions between the relevant ABA Model Rules and the Texas Rules, and difficulties that an attorney representing an insolvent debtor may face when confronted with this "legal ethics nightmare."

## The Committee's Analysis Factual Background

The committee identified the following six situational conditions material to its opinion:

## Feature

1. A single individual controls the ownership and management of the corporation;
2. The corporation is insolvent;
3. The lawyer representing the corporation has concluded that the managing individual is engaging in conduct in breach of his or her fiduciary duties to the corporation;
4. The offensive conduct is likely to cause significant harm to the corporation's creditors;
5. The attorney has advised the managing individual that his or her conduct is in breach of his or her fiduciary duties to the corporation and should be stopped; and
6. The managing individual disregards the advice and specifically instructs the attorney not to make disclosure to the corporation's creditors.

## Cornerstone Obligation of Confidentiality

The committee initially emphasized the fundamental obligation of an attorney to preserve "confidential information" and supported it by quoting from Comment 1 to Disciplinary Rule 1.05(b) as follows:

<sup>4</sup> *Id.* at 74.

"Both the fiduciary relationship existing between the lawyer and client and the proper functioning of the legal system require the preservation by the lawyer of confidential information of one who has employed or sought to employ the lawyer." Comment 1 to Rule 1.05 of the Texas Disciplinary Rules of Professional Conduct. Conclusions reached by a lawyer regarding the conduct of a corporate client's representative and the resulting advice that the lawyer gives to the corporation are "confidential information" as defined in Rule 1.05d(a).<sup>5</sup>

## Exceptions to the Obligation of Confidentiality

After emphasizing the duty to preserve client confidentiality, the committee considered the confidentiality excep-

tions provided in Rule 1.05. It first noted the obvious inapplicability of the *mandatory disclosure* exception provided in Disciplinary Rule 1.05(e), which requires disclosure to the extent necessary to prevent the client's applicable criminal or fraudulent acts when such acts are likely to result in death or substantial bodily harm. The committee next addressed the *permissive disclosure* exceptions to confidentiality, focusing on the exception provided in Rule 1.05(c)(7), which reads in pertinent part:

[A] lawyer may reveal a client's confidential information "[w]hen the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or [actual] fraudulent act."<sup>6</sup>

Critical to the committee's analysis is whether management's breach of fiduciary duty constituted actual (*i.e.*, deceptive) fraud as opposed to constructive fraud. If actual deception is not present, the committee concluded that "*nothing*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

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in the Texas Disciplinary Rules would authorize the lawyer to reveal the lawyer's conclusions and advice to the corporation's creditors."<sup>7</sup>

## Committee's Ultimate Conclusion

In the end, the committee concluded that an attorney is never required to disclose confidential information to creditors but, under the facts presented, may make such disclosure if (1) management's breaches of fiduciary duty would cause the corporation to engage in actual fraud, (2) the actual fraud would likely result in substantial financial harm to the creditors, (3) the lawyer has attempted, unsuccessfully, to dissuade management from committing the fraud, (4) the lawyer believes disclosure to the creditors will prevent the fraud and (5) the lawyer believes no less-drastic action will prevent the fraud. If any one of these five factors is missing, the committee concluded, disclosure would violate the attorney's obligation of confidentiality.

## Resolution of "Legal Ethics Nightmare": Practical Problems

Two assumptions by the committee limit practical application of the opinion: the assumption that the client representative's offensive conduct was not likely to cause any material harm to the corporation because the corporation was insolvent, and the assumption that under the facts presented, none of the mandatory disclosure provisions of Rule of Professional Conduct 1.05(f) applied.

With respect to the first assumption, it is not necessarily true that an insolvent corporation cannot suffer damages resulting from breaches of fiduciary duty by one of its managers. For example, a fundamental purpose of reorganizational chapter 11 plans is the preservation of the debtor's going-concern value, and that value could be significantly damaged or destroyed as a result of management's breaches of their fiduciary duties.

Damage to the "client" entity, as opposed to damage only to third parties, such as creditors, implicates Texas Rule 1.12(b), which requires the lawyer to take reasonable remedial actions if the lawyer learns that an agent of his or her client has committed or intends to commit either a violation of a legal obligation to the client or a violation of a law that

reasonably might be imputed to the client if the violation is likely to result in substantial injury to the client.

The remedial actions contemplated by Rule 1.12(b) are not restricted to actions internal to the client organization. Indeed, Comment 7 to Rules 1.12 and 1.12(c) both refer specifically to an attorney's duty to reveal information to persons outside the organization. Comment 7 reads, in relevant part:

The ultimate and difficult ethical question is whether the lawyer should circumvent the organization's highest authority when [the highest authority] persists in a course of action that is clearly violative of law or a legal obligation to the organization and is likely to result in substantial injury to the organization. These situations are governed by Rule 1.05... If the lawyer does not violate a provision of Rule 1.02 or Rule 1.05 by doing so, the lawyer's further remedial action, after exhausting remedies within the organization, may include revealing information relating to the representation to persons outside the organization.

However, the mandates of Rule 1.12 are not the only provisions of the Texas Disciplinary Rules of Professional Conduct that could impose an obligation to disclose confidential information to the creditors of an insolvent corporation. Texas Rule 1.05(f) requires that a lawyer reveal confidential information "when required to do so by Rule 3.03(a)(2), 3.03(b), or by Rule 4.01(b)."<sup>8</sup>

Under Rule 4.01, an attorney is required to disclose information to third parties (e.g., creditors) to the extent necessary to avoid making the lawyer a party to a criminal act or knowingly assisting a fraudulent act perpetrated by a client. For whatever reason, the committee assumed that Rule 1.05(f) was inapplicable and left unaddressed possible Rule 4.01 disclosure requirements.

Rules 1.05(f) and 4.01 are of practical importance when determining whether disclosure to creditors should or must be made<sup>9</sup> because most debtors' attorneys routinely have substantial com-

munications with creditors,<sup>10</sup> and creditor lawsuits against a debtor's attorney are typically based on theories such as negligent misrepresentation,<sup>11</sup> aiding and abetting breaches of fiduciary duty by the client<sup>12</sup> and conspiracy with the client.<sup>13</sup>

## Relevant Texas Rules of Professional Conduct Compared with ABA Model Rules

The ABA Model Rules of Professional Conduct,<sup>14</sup> in some respects, favor even more the protection of confidentiality than do the Texas Rules. The ABA Model Rule of Professional Conduct comparable to Texas Rule of Professional Conduct 1.05 is 1.6. Unlike its Texas counterpart, ABA Model Rule 1.6 does not include any mandatory disclosure requirements. This dramatic distinction is well illustrated by the difference between the two rules dealing with the prevention of death or serious bodily harm. Texas Rule 1.05(e) requires disclosure if reasonably necessary to prevent a criminal or fraudulent act that is likely to result in death or serious bodily harm. ABA Model Rule 1.6(b)(1), on the other hand, permits—but does not require—a lawyer to disclose confidential information if reasonably necessary to prevent reasonably certain death or bodily harm.

With respect to the fact situation described in Opinion 603 and the issue of permissive disclosure, the ABA Model Rule again favors more protection of confidentiality. Whereas the Texas Rule requires the attorney to consider, among other factors, the probability and magnitude of the financial or property injury, ABA Model Rule 1.6(b)(2) permits disclosure only if the probability of injury is "reasonably certain" and the magnitude of the potential injury is "substantial."

As discussed, an attorney proceeding under Texas Rule 1.12 dealing with representation of an organization "must take

<sup>9</sup> Texas Disciplinary Rules of Professional Conduct do not establish a standard of care, and violations of them do not typically create a basis for civil liability by clients or third parties, and potential civil liability is not an issue with the committee. See, e.g., Texas Disciplinary Rules of Professional Conduct, Preamble paragraph 15. The converse is not true. Misconduct by the attorney triggering civil liability exposure to clients and third parties can also result in violations of ethical duties. See, e.g., *Peirillo v. Bachenberg*, 655 A.2d 1354, 1357 (N.J. 1995).

<sup>10</sup> Distribution of disclosure statements and reorganizational plans are examples. Even the disclosures to creditors contemplated by Opinion 603 would be communications with third parties subject to the ethical mandates of Rule 4.01.

<sup>11</sup> *McCain v. Martin, Brown & Loeffler v. F.E. Appling Interests*, 991 S.W.2d 787 (Tex. 1999).

<sup>12</sup> *ABBank v. Holmes (In re TUCFHE Inc.)*, 413 B.R. 523 (Bank. N.D. Tex. 2009).

<sup>13</sup> *Id.*

<sup>14</sup> Most states have adopted some form of the ABA Model Rules. None have adopted them verbatim.

<sup>7</sup> *Id.* (emphasis added).

<sup>8</sup> Rules 3.03(a)(2) and 3.03(b) address a lawyer's obligations of candor toward courts. Rule 4.01 addresses the lawyer's obligations of truthfulness in statements to others (such as creditors).

remedial action” under the described circumstances to prevent “substantial harm” to the organization as a “likely” result of the misconduct by one of the organization’s agents. ABA Model Rule 1.13(b) states that under such circumstances, the lawyer “shall proceed as is reasonably necessary in the best interest of the organization.” ABA Model Rule 1.13(c) clearly contemplates disclosure outside the organization and, in contrast to the Texas Rule, adds that such disclosure can be made even if otherwise prohibited by ABA Model Rule 1.6.

With respect to situations implicating ethical rules dealing with representations to third parties, there is one significant distinction between the ABA Model Rule 4.1 and Texas Rule 4.01: Both require disclosure if necessary to avoid knowingly assisting a criminal or fraudulent act perpetrated by a client. However, ABA Model Rule 4.1(b) contains the restriction “unless disclosure is prohibited by Rule 1.6.” It is difficult to imagine under what circumstances ABA Model Rule 1.6 would prohibit sufficient disclosure to protect the attorney

from knowingly assisting a criminal or fraudulent act perpetrated by a client.

In the *Rohrbach* case, the appellate court resolved that “legal ethics nightmare” against the attorney. It concluded that mere silence by an attorney who, in reliance on his duty to preserve client confidences, knowingly failed to correct his client’s identity deception to an investigating officer at a presentence investigation constituted a violation of ABA Model Rule 4.1 (misrepresentation to third parties), justifying a 45-day suspension.<sup>15</sup>

### Conclusion

Where management of an insolvent debtor has breached—or is breaching—its fiduciary duties, the attorney representing that debtor faces an increased level of personal risk. Failure by the attorney to recognize that risk and implement appropriate action can result in severe consequences, including formal grievances, court sanctions and direct or derivative civil lawsuits against the attorney for, *inter alia*, breach of

fiduciary duty, legal malpractice, aiding and abetting breaches of fiduciary duty and conspiracy. Possible “appropriate action” generally cannot be limited to consideration of the permissive disclosures such as those described in Texas Rule 1.05(c)(7), but should include consideration of the various mandatory disclosure requirements.<sup>16</sup>

Avoiding or minimizing exposure to such undesirable consequences begins with diligent and documented efforts to stop or correct management’s breaches of fiduciary duties. Once such internal efforts have been exhausted and proven futile, the attorney must consider more drastic options, including resignation or making disclosure to a creditor or the creditor body. The extent of any disclosure will be fact-specific, but should be as limited as reasonably necessary to prevent the crime, fraud or resulting injury. Caution is required to ensure that such disclosures in themselves are not misleading. ■

<sup>16</sup> If disclosure to creditors or other third parties may be necessary, Comment 6 to Texas Rule 1.12 suggests that “[a]t some point it may be useful or essential to obtain an independent legal opinion.”

<sup>15</sup> *Rohrbach*, *supra*, at 591 A.2d 497-99.

## Financial Statements: Peace of Mind for Banks and Regulators

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Amendment<sup>4</sup> puts the onus on regulators to make sure that insured depository institutions and depository holding companies retain enough capital to absorb losses during periods of market dislocation. To that end, the Dodd-Frank Act mandates annual stress tests under various types of economic conditions for banks with more than \$50 billion in assets.

### Greater Relevance, Wider Application

The Dodd-Frank Act was aimed squarely at larger financial institutions with systemic-risk potential. However, the implications of risk for smaller and midsize regional banks are equally applicable. While larger banks were shoring up their tier 1 capital levels—the primary gauge of a bank’s strength relative to its assets—community banks took the recession on the chin in 2009. Most banks were well-capitalized before the housing market crisis and economic downturn,

but the substantial increase in nonperforming loans and defaults sapped loan loss reserves and portfolio performance. Credit for businesses dwindled, and capital for banks dried up. In the aftermath, the number of bank failures soared to 140, according to FDIC statistics.

In 2010, 157 banks failed, a 12 percent increase from 2009. To put those failure rates into perspective, the total for the past two years exceeds the cumulative total for the previous eight years. Despite stabilization in the nation’s equity and debt-capital markets and improving economic conditions, the capacity to sustain large loan losses and continue lending in a difficult economic environment remains a questionable prospect for many community and smaller banks. This article uses these terms interchangeably.

Regulators have not yet required banks with less than \$10 billion in assets to perform stress tests, but the financial fallout from nonperforming loans is an all-too-real risk for banks of all sizes. Large numbers of distressed residential properties and foreclosures, coupled with declining home prices, continue to cast a long shadow over the housing market. At the same time, sluggish economic

growth, troubled commercial real estate assets and an unemployment rate that the Department of Labor calculated at 9.4 percent in December 2010 are all clouding the horizon for the banking industry.

Federal Reserve Chairman Ben Bernanke underscored the importance of stress testing for all banks on May 6, 2010, when he said that bankers (and other financial services firms) need to conduct their own stress tests. He explained that the tests “force bankers to think through the implications of scenarios that may seem relatively unlikely but could pose serious risks.... Stress tests must be an integral part of [firms’] processes for ensuring their capital is adequate.”<sup>5</sup> These developments highlight the need for management and boards of directors to conduct thorough analyses of their banks’ loan and investment portfolios and operations, including the impact on net interest margin, fee income and other sources of revenue and loss impairment, as well as an ongoing review of internal processes and controls, in order to assess and manage risk appropriately.

<sup>4</sup> The provisions of the Collins Amendment are contained in § 171 of the Dodd-Frank Act. Section 171 directs the appropriate federal banking agencies to establish minimum leverage and risk-based capital requirements, on a consolidated basis, for insured depository institutions, depository institution holding companies and nonbank financial companies that are supervised by the Federal Reserve. The Collins Amendment will create statutory floors for minimum leverage and risk-based capital and U.S. banking regulators would be able to implement Basel III only to the extent it is consistent with the Collins Amendment floor.

<sup>5</sup> Chairman Ben Bernanke at the Federal Reserve Bank of Chicago presenting at the 46th Annual Conference on Bank Structure and Competition on May 6, 2010.

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