Hot Ethics Issues in Bankruptcy Practice: Disclosure, Social Media, Civility, Artificial Intelligence

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Disclosure Requirements for Estate Professionals

Distinguish Bias from Conflicts of Interest

Conflicts are governed by the Code of Professional Responsibility

Bankruptcy Rule 2014 covers conflicts disclosure, but is rooted in the purpose of ferreting out bias

BIAS

- Bias disclosures are inextricably intertwined with the important bankruptcy policy of transparency. The basic objective is to assure that professionals are not engaged in favoritism in dealing with particular parties in interest or professionals to the detriment of non-favored parties.

Bankruptcy Rule 2014

Employment of Professional Persons

(a) *Application for and Order of Employment*. An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to section 327, section 1103, or section 1114 of the Code shall be made only on application of the trustee or committee. The application shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States trustee. The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, <u>***all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee***</u>. The application shall be accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. (emphasis supplied)

McKinsey and the UST

- McKinsey RTS (Recovery & Transformation Services) attempted in substance to wall off the rest of the McKinsey corporate empire from the disclosure obligations of Rule 2014. These efforts concealed investments that other branches of McKinsey had in the debtor clients that McKinsey Recovery was engaged to represent, and were challenged in a variety of cases by AlixPartners and the Office of the United States Trustee. According to AlixPartners, McKinsey lied in more than a dozen corporate bankruptcy cases to avoid revealing numerous conflicts of interest that should have disqualified it from being brought on to work out reorganization plans

McKinsey

On Feb. 19, 2019, McKinsey and the United States Trustee reached a $15 million settlement that resolved disputes over the adequacy of McKinsey's disclosures in three chapter 11 cases. The UST alleged that McKinsey's disclosures about its clients and investments in certain business entities that were connected with the debtors that employed McKinsey to provide financial advice on their respective bankruptcy reorganizations were insufficient.

In particular, the UST argued that McKinsey had failed to identify certain clients who were connected with the debtors it represented and it was not entirely forthcoming about its investments that gave rise to a possible conflict of interest.

UST Program Position Paper

FAQ: “Connections” is ridiculously broad. Do I really need to disclose every connection?

<u>Disclose Connections on the Public Record</u>.

“It is the USTP's position that relevant bankruptcy law requires professional firms to disclose on the public record their connections to a case, even if they have a contractual arrangement to keep client information, including client names, confidential. The USTP will argue that a professional firm required to disclose information must either publicly disclose it on the record or file a properly supported motion to seal it under section 107 of the Bankruptcy Code for the court to adjudicate. Should the professional firm choose to file a motion to seal rather than publicly disclose the required information on the record, the USTP has a responsibility to object to any motion that does not satisfy the high bar for sealing.”

Memorandum from Clifford J. White III, Director of UST Program (Dec. 4, 2019), https://www.justice.gov/file/1223106/download.

UST Program Position Paper

Disclose Affiliate Connections.

“It is the USTP's position that a professional firm being employed must disclose the connections of ***all its affiliates***. Every case is fact specific and, in some circumstances, a *professional firm may be able to show that it is sufficiently separate from its affiliates to excuse affiliate disclosure*. The applicant seeking to employ the professional firm bears the burden of proof and only the court has authority to excuse affiliate disclosure.” *Id. (emphasis supplied)*

Judicial Disclosure Rules: The Curious Case of Judge Jones

Former United States Bankruptcy Judge David Jones (Southern District Texas, Houston Division) is alleged to have presided in over 16 chapter 11 cases, during which he approved more than $1 million in fees billed by former Jackson Walker LLP partner Elizabeth Freeman, and more than $6 million in fees billed by the Jackson Walker firm.

Throughout that time, according to a complaint filed in October 2023 by a shareholder of a debtor in one of those cases, Jones and Freeman maintained an intimate relationship and lived together in a home, whose deed and survivorship agreement make clear that they are both owners of the house, and that the survivor of the two of them inherits the property. Neither Jones nor Jackson Walker disclosed the relationship in any of those cases.

THE FIRM SAYS….

A spokesman for Jackson Walker said the Firm consulted outside ethics counsel after learning about the romantic relationship in March 2021.

> "From the time we first learned of this allegation Ms. Freeman was instructed not to work or bill on any cases before Judge Jones," Jackson Walker spokesman Jim Wilkinson said. "We are confident that we acted responsibly."
>
> It is not clear what procedures Jackson Walker followed in its responsibilities to comply with Bankruptcy Rule 2014, either prior to or subsequent to Freeman's cessation of work on the cases. Nor is it clear whether their assertion that they acted responsibility means their instruction that she stand down or something more.

Compliance with Rule 2014

In cases in front of Judge Jones in which attorney Freeman was engaged, she had personal knowledge of her relationship with the Judge. Was this required to be disclosed under Rule 2014?

In cases in front of Judge Jones in which attorney Freeman was not involved, did other bankruptcy lawyers at Jackson Walker know of the relationship and were they required to disclose it? Were all lawyers at Jackson Walker canvassed at any time about their knowledge of any such relationship?

AND THEN....

- The U.S. Trustee's Office has filed motions to undo Jackson Walker's fee awards in at least 11 cases, including the major bankruptcy cases of J.C. Penney Co. and Neiman Marcus
  - U.S. Trustee's Office request to delay the payment of $1.3 million in fees and expenses to Jackson Walker in the bankruptcy case of GWG Holdings Inc. granted
  - The plan agent in the 4E Chapter 11 case, at the judge's urging, has proposed a modified plan that would allow unsecured creditors to recover fees disgorged by Jackson Walker
- Potential for many other fee awards to come into question
  - Judge Jones awarded Jackson Walker more than $12 million in fees in at least 26 cases he presided over while Freeman was a partner at the firm.
  - *Kirkland & Ellis was awarded over $162 million in fees as lead counsel in cases before Judge Jones in which Jackson Walker served as co-counsel*

Disclosure/Recusal Requirements for Bankruptcy Judges

28 U.S. Code § 455

(a) Any justice, judge, or magistrate judge of the United States shall disqualify himself in any proceeding in which his impartiality might reasonably be questioned.

(b) He shall also disqualify himself in the following circumstances:

(1) Where he has a personal bias or prejudice concerning a party, or personal knowledge of disputed evidentiary facts concerning the proceeding;

* * * *

(4) He knows that he, individually or as a fiduciary, or his spouse or minor child residing in his household, has a financial interest in the subject matter in controversy or in a party to the proceeding, or any other interest that could be substantially affected by the outcome of the proceeding;

- (5) He or his spouse, or a person within the third degree of relationship to either of them, or the spouse of such a person:
- (i) Is a party to the proceeding, or an officer, director, or trustee of a party;
- (ii) Is acting as a lawyer in the proceeding;
    - (iii) Is known by the judge to have an interest that could be substantially affected by the outcome of the proceeding;
  - (iv) Is to the judge’s knowledge likely to be a material witness in the proceeding.
  - *455(d) provides that “for the purposes of this section . . . (2) the degree of relationship is calculated according to the civil law system.”*

Disclosure/Recusal Requirements for Bankruptcy Judges

Code of Conduct for United States Judges (adopted by the Judicial Conference, April 5, 1973)

Canon 1: A judge should uphold the integrity and independence of the judiciary

Canon 2: A judge should avoid impropriety and the appearance of impropriety in all activities

Commentary: An appearance of impropriety occurs when reasonable minds, with knowledge of all the relevant circumstances disclosed by a reasonable inquiry, would conclude that the judge's honesty, integrity, impartiality, temperament, or fitness to serve as a judge is impaired... A judge must avoid all impropriety and appearance of impropriety... Because it is not practicable to list all prohibited acts, the prohibition is necessarily cast in general terms that extend to conduct by judges that is harmful although not specifically mentioned in the Code.

Disclosure/Recusal Requirements for Bankruptcy Judges

Canon 3: A Judge Should Perform the Duties of the Office Fairly, Impartially and Diligently: *(C) Disqualification*. (1) A judge shall disqualify himself or herself in a proceeding in which the judge's impartiality might reasonably be questioned, including but not limited to instances in which . . . (d) the judge or the judge's spouse, or a person related to either within the third degree of relationship, or the spouse of such person is . . . (ii) acting as a lawyer in the proceeding; (iii) known by the judge to have an interest that could be substantially affected by the outcome of the proceeding. . . .

- Commentary to Canon 3C: *Recusal considerations applicable to a judge's spouse should also be considered with respect to a person other than a spouse with whom the judge maintains both a household and an intimate relationship.*

Duty to Supplement

- Current Rule 2014 – vague and undefined; not clear under applicable judicial precedents when the duty to supplement arises. But cases do recognize a duty to supplement:

- “[T]here is an ongoing obligation to supplement the disclosure if the applicant later learns of undisclosed connections or conflicts later arise.” *In re Gluth Bros. Const., Inc.*, 459 B.R. 351, 364 (Bankr. N.D. Ill. 2011).

- “Full disclosure is a continuing responsibility on the part of the professional employed by the trustee.” *In re Tomczak*, 283 B.R. 730, 735 (Bankr. E.D. Wis. 2002).

- FAQ:
- How often should professionals supplement their disclosures under Rule 2014?

- Proposed Rule 2014 (best practices) – establishes minimum requirements of updated searches and supplemental disclosures (if appropriate) before filing any adversary proceeding (or response if the retained professional is on the defense side), within 28 days after any amendment to bankruptcy schedules, whenever a bidder for assets is publicly identified, and before any interim or final fee application.

Other Retention and Disclosure Issues

- Independent Directors -

Are they required to be employed under chapter 3 and are they required to disclose connections?

- *In re eToys*, 331 B.R. 176, 201–02 (Bankr. D. Del. 2005) (observing that even though officers are not "professionals", court has power to supervise and deny compensation and that officers should disclose potential conflicts").
- *In re Schatz Fed. Bearings Co.*, 17 B.R. 780, 782–84 (Bankr. S.D.N.Y. 1982) (observing that two directors of the debtor, who "[a]part from their appointments as directors, for which they were compensated … were retained by the debtor because of their professional and financial acumen … [and] are clearly within the category of professional persons who may be employed by the debtor only with the court's approval, as required by Code § 327.") (emphasis added).
- *In re Madison Mgmt. Grp., Inc.*, 137 B.R. 275, 283–84 (Bankr. N.D. Ill. 1992) (finding that an independent director was a professional for Section 327 purposes and that "[t]he determination [is] made on a case-by-case basis. A professional is a person whose occupation plays a central role in the administration of the bankruptcy case.").

Independent Directors

- In re MusclePharm Corporation
- Final DIP Order appointed Nicholas Rubin to Debtor's Board of Directors as an "independent director"
- Rubin and his firm, Force Ten Partners, LLC, had recently been involved in two chapter 11 cases in which they were engaged by debtors represented by Empery's counsel
  - Empery was the DIP lender in this case and, apparently, hated Ryan Drexler, who filed a motion for the appointment of a Chapter 11 Trustee
  - Empery paid Rubin's fees as Debtor's independent director
  - Neither the Debtor nor any other party disclosed this connection to the court

Ethics and Social Media

You do not cease being a lawyer when you communicate over social media. Hence the Code of Professional Responsibility continues to apply.

Code of Professional Responsibility Rule 8.2(a):

"(a) A lawyer shall not make a statement that the lawyer knows to be false or with reckless disregard as to its truth or falsity concerning the qualifications or integrity of a judge, adjudicatory officer or public legal officer, or of a candidate for election or appointment to judicial or legal office."

Ethics and Social Media

In re McCool, 2015 WL 3972684 (La. Sup. Ct. June 30, 2015)

- Attorney lost her license to practice law after organizing online petition criticizing judges who ruled against her.
- Attorney McCool represented a friend’s new husband in various custody battles in two different states and sought to terminate the ex-husband’s parental rights.
- She was unsuccessful.
- Attorney McCool then took to social media and orchestrated an online petition, which she posted to her blog. In short, the petition solicited and encouraged members of the public to contact the judges involved to express their feelings to the court about the pending cases.
- One judge received an email from a signer of the petition that stated she was a voter and would “be paying attention” to Attorney McCool’s case.

Ethics and Social Media

In re McCool, 2015 WL 3972684 (La. Sup. Ct. June 30, 2015)

- Despite the evidence in the case being sealed, Attorney McCool posted audio recordings of the children describing sexual abuse at the hands of the ex-husband online.
- The disciplinary board found Attorney McCool's online conduct so egregious that it revoked her law license.
- The Attorney's online conduct was tantamount to undue influence of a tribunal under ABA Rule 3.5

The Ethics and Practice of Civility

- Email -

1. Every message from the important to the mundane carries an insistence of immediate response. We have deceived ourselves into believing that emails are generally a “good” thing because they speed our communications and make us more efficient. No one, however, has measured the consequence in time required to “fix” all the problems that emails create.

2. Email is some evil spawn of the unholy union of phone and hard copy correspondence, with a few genes from the person who barges uninvited into your office.

3. Our brains consistently fool us into thinking that emails are ephemeral, fleeting communications, like phone calls, that disappear after we hit “send.” In fact they are permanent records, even if they are “deleted.”

4. Of the four major forms of professional communication: in-person, telephonic, hard-copy correspondence and emails, email is the worst way to detect or understand nuance and meaning. Email communications are frequently misunderstood, and offense is often taken unnecessarily.

5. Conversely, emails are also the best weapons for bullies because when they are intended to be used to offend, they can offend easily and to a wide audience with little effort.

DO NOT REPLY ALL

This is a key indicator of the failure to reflect. This mistake usually is only made when the sender is reacting so quickly that she does not take the few extra seconds to see that "reply all" is the selected option.

Reply all ONLY when there is no alternative.

Stop saying that your silence, or unwillingess to respond, or failure to address every single thing in someone's letter or email means you disagree with it. No one ever made a rule like that. Be concise and respond only to what is needed. Just because you don't respond does not make the assertions true. You don't have to answer every email.

ABA Formal Opinion 503
November 2, 2023

“Reply All” in Electronic Communications

- “In the absence of special circumstances, lawyers who copy their clients on an electronic communication sent to counsel representing another person in the matter impliedly consent to receiving counsel’s ‘reply all’ to the communication.”
- “Unless otherwise explicitly agreed, the consent covers only specific topics in the initial email; the receiving counsel cannot reasonably infer that such email opens the door to copy the sending lawyer’s client on unrelated topics.”
- Opinion does not apply where there is an “express oral or written remark informing receiving counsel that the sending lawyer does not consent to a reply all communication [that] would override the presumption of implied consent.”

The Ethics of Using Generative Artificial Intelligence

In re: Pleadings Using Generative Artificial Intelligence, Gen. Order No. 2023-03, issued Wednesday by N. D. Texas Bankruptcy Court Chief Judge Stacey G. C. Jernigan:

“If any portion of a pleading or other paper filed on the Court's docket has been drafted utilizing generative artificial intelligence, including but not limited to ChatGPT, Harvey.AI, or Google Bard, the Court requires that all attorneys and pro se litigants filing such pleadings or other papers verify that any language that was generated was checked for accuracy, using print reporters, traditional legal databases, or other reliable means. Artificial intelligence systems hold no allegiance to any client, the rule of law, or the laws and Constitution of the United States and are likewise not factually or legally trustworthy sources without human verification. Failure to heed these instructions may subject attorneys or pro se litigants to sanctions pursuant to Federal Rule of Bankruptcy Procedure 9011.”

- On June 22, 2023, the United States District Court for the Southern District of New York sanctioned two personal injury attorneys for submitting fake citations with fake quotes
  - Judge emphasized that it was not inherently improper to use AI tools, but that attorneys had a duty to ensure the accuracy of their filings
  - Fined attorneys $5,000 and ordered them to inform both their client as well as the real judges that ChatGPT created fake citations for
- Attorney stated that he used ChatGPT because he lacked the research tools and databases for federal cases
- Sanction exacerbated by the fact that attorneys waited two months after opposing counsel submitted a brief stating that they could not locate the cases cited to admit
  - One attorney falsely claimed to be on vacation, in an attempt to buy time, and the other submitted an affidavit that purported to show bits and pieces of the nonexistent cases

Ethics And AI

- On January 30, 2024, The Second Circuit referred Jae S. Lee, University of Wisconsin Law School S.J.D., to the Second Circuit's grievance panel for punishment for submitting a brief citing a fake case generated by ChatGPT
  - Court stated that Lee failed to make reasonable into the validity of arguments presented required under FRCP Rule 11
  - Lee stated that she turned to ChatGPT after failing to find a case to support her argument
- Lee warned the panel reprimanding her that "it would be prudent for the court to advise legal professionals to exercise caution when utilizing [ChatGPT]"
  - To which the panel replied "[specific local rules are] not necessary to inform a licensed attorney, who is a member of the bar of this court, that she must ensure that her submissions to the court are accurate"

Ethics And AI

- In November 2023, the Fifth Circuit released the proposed change to its certificate of compliance rules to address the use of AI
  - Requires attorneys to verify that documents were not written using generative AI and, if they were, that they were reviewed for accuracy by humans
  - "[M]aterial misrepresentation" of whether generative AI was used in a court document may result in sanctions and the court tossing the document
- The 9th Circuit is in the process of forming an AI panel
  - Specific goals of the panel remain unclear
- Many judges have issued standing orders or varying breadth against the use of generative AI

ETHICS AND AI

- Chief Justice Roberts' 2023 Year-End Report on the Federal Judiciary
  - "Legal research may soon be unimaginable without [AI]"
  - May "increase access to justice, particularly for litigants with limited resources"
    - References courts' monopoly over many forms of relief, including bankruptcy
  - Raises the issues of generative AI "hallucinations" and compromising confidentiality by entering it into an AI tool
  - "As AI evolves, courts will need to consider its proper uses in litigation"
  - States that, at least in the foreseeable future, AI will not be able to replace trial and appellate judges

Cryptofraud and Legal Ethics

Professor Douglas G. Baird, University of Chicago Law School

Professionals face special challenges when the whiff of serious misconduct is strong, especially if the professionals have already done work prepetition. Of course, there are challenges whenever professionals have done work prepetition. They are creditors to the extent that there is any prepetition work for which they are unpaid. A professional who holds a retainer as security for payment might also be a creditor. Any who have been paid for prepetition services within ninety days of the petition is potentially subject to a preference attack. But matters are especially hard when fraud is in the air.

Whether someone is a "disinterested person" turns largely on whether the person has an interest materially adverse to the interests of the estate or any class of creditors or equity holders. 11 U.S.C. §101(14)(C). Past representation of a debtor does not itself render someone disinterested, and for good reason. It makes little sense to define "disinterested" narrowly. Those who helped the debtor navigate financial distress before bankruptcy might be those best equipped to help it in bankruptcy. Again, there must be an actual (as opposed to potential) conflict for a professional not to be disinterested.

Matters become more complicated, however, when the debtor faces serious charges of wrong-doing and the bankruptcy itself may require scrutiny of transactions in which professionals may have played a significant role. This problem was brought front and center during the *FTX* bankruptcy.

FTX ran a large cryptocurrency trading platform. FTX itself was a corporate group with over a hundred related entities. Cash, cryptocurrencies, and securities sloshed between corporate entities, including cash and cryptocurrency that FTX was supposed hold on behalf of its customers. And there were many corporate acquisitions. Some of these were suspect, and FTX might have dramatically overpaid for others. The CEO was about to be arrested at the time of the petition and was later, along with other principal officers, convicted and sentenced to a long prison term.

More to the point, at the start of the *FTX* bankruptcy, even understanding the firm's financial condition was impossible. FTX's new and able CEO observed in his first-day declaration, "[n]ever in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here." And this was coming from someone who had sorted out the mess that was *Enron*. See Declaration of John J. Ray III in Support of Chapter 11 Petitions and First Day Pleadings, In re FTX Trading Ltd, No. 22-11068 (Bankr. D. Del. Nov. 11, 2022).

One of the issues that figured prominently in *FTX* was its retention of a law firm that had done work for it before the bankruptcy. The Third Circuit required the appointment of an examiner in the case to look at whether debtor's counsel was disinterested. See In re FTX Trading Ltd., 91 F.4th 148 (3d Cir. 2024). A forthcoming law review article takes an especially dark view of the role that these lawyers played before the petition. See Jonathan C. Lipson & David Skeel, FTX'd Conflicting Public and Private Interests in Chapter 11, 77 Stan. L. Rev. • • • (forthcoming 2025), available at https://ssrn.com/abstract=4760736.

Two sorts of questions were raised about the law firm's prepetition conduct. First, it appears that just before the filing of the petition, the law firm reached out to the government and made disclosures without the knowledge or permission of the CEO. Second, questions were raised about whether the work the law firm did before the bankruptcy kept it from being disinterested. The law firm had done $8 million dollars of work for the debtor, and the law firm had also done $195,000 of work for the CEO. (As with most of the law firm's work for the debtor, the work for the CEO was regulatory compliance, in this case Hart-Scott-Rodino compliance with respect to the CEO's acquisition of stock in Robinhood.)

The examiner appointed in the wake of the Third Circuit's opinion ultimately concluded that there were insufficient grounds to find that the law firm was not disinterested. The examiner did identify to one issue (the work the firm had done for the CEO prepetition) that required further study. That supplemental report is due shortly.

It is worthwhile to back away from the specific facts of FTX's chapter 11 and look broadly at these two issues—the ability and duty to disclose wrongdoing and the sorts of prepetition work that prevent a law firm from being disinterested.

Disclosure and Client Confidentiality

Lawyers owe their clients a duty of confidentiality. This duty is qualified, however. Indeed, for a transactional lawyer the greatest danger may be quite the opposite of failing to maintain client confidences. Lawyers also need to worry about liability that arises from a failure to disclose client misconduct. When a lawyer represents a client, discovers that transactions are shady, and then fails to act, the lawyer may face legal exposure. Liability for representing a dishonest client is the source of more than two-thirds of the $20 million judgments against or settlements by law firms. See Douglas R. Richmond, Lawyers' Duty of Confidentiality and Clients' Crimes and Frauds, 38 Ga. State U. L. Rev. 493 (2022).

If a lawyer discovers that the client has engaged in illegal conduct using the lawyer's services, disclosure is permitted under the Model Rules and typically under the rules of professional conduct as enacted by states as well. Specifically, there is a rule that adopted in the wake of *Enron*. As the history behind the rule explained:

> [W]here the client abuses the client-lawyer relationship by using the lawyer's services to commit a crime or fraud that results in substantial economic harm to another, the policy of protecting confidentiality is outweighed by the policy of protecting the interests of society and the professional integrity of the lawyer.

More specifically, Model Rule 1.6(b)(2) allows lawyers to disclose "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." And Model Rule 1.6(b)(3) allows disclosure "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."

Moreover, the lawyer's duty is to the client, and lawyers who work with distressed debtors typically represent an organization. Loyalty is owed to the organization, not to those who work for the organization. If a lawyer discovers that someone working at an organization has acted dishonestly, it is almost always in the organization's own interest to report the behavior. Indeed, in a regulatory environment, disclosures by the client are likely mandatory if disclosure is needed to correct information previously filed with the regulator. (This may have been the case with *FTX*.)

The challenge is usually navigating exactly how disclosure should be made and what must steps must be taken inside the organization before the disclosure is made. Sometimes there is no conflict between the lawyer and the organization at all. The lawyer recommends disclosure to the person with whom the lawyer regularly interacts, and that person has the power to authorize the disclosure and does so. Hard questions arise when this avenue is not available.

How exactly should the lawyer proceed in this environment? Section 1.13(b) of the Model Rules provide:

> 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.

But, of course, what happens when the highest authority is in fact the person who may have engaged in suspect conduct? Model Rue 1.3(c) provides that if

> despite the lawyer's efforts . . . 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 . . . 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 . . . , but only if and to

the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization**.**

In *FTX*, the law firm did make some disclosures to the government before the petition with the consent of the general counsel for one of the FTX entities, but the law firm never notified the CEO of its intention to disclose. Exactly what these disclosures were (whether simply correcting a previous regulatory filing or reporting criminal conduct) is not clear. Some have asserted that the law firm should not have acted without consulting first with the "highest authority" in the organization. By this account, the CLO of one of the related entities who blessed the disclosure lacked the authority to do so.

As in many other ethics cases, the matter is fact dense. The law firm violated no ethical duties if it was merely making disclosures that were approved by the appropriate chief legal officer. Nor does a lawyer likely violate legal duties if the lawyer discovers outright fraud and talking with the CEO would only compound the fraud. Unfortunately, there is much that falls between the two extremes.

Conflicts

Potential conflicts are inevitable in the representation of large firms in bankruptcy. Among other things, if the debtor is a corporate group and there exists ordinary intercorporate debt, each corporation is a separate debtor, and each debtor is both a creditor and a debtor of everyone else in the group. A lawyer representing the group is representing each of the debtors in the group. Such a lawyer is necessarily representing a debtor and creditors of that debtor at the same time.

Courts have long recognized that finding a disqualifying actual conflict in this environment makes little sense. "Requiring appointment of independent professionals to represent each individual debtor in all such cases, regardless of the factual circumstances, would burden estates with unjustified and insurmountable costs." In re Adelphia Communications Corp., 342 B.R. 122, 128 (S.D.N.Y. 2006).

Similarly, doing prepetition work for the debtor is not disqualifying either. There are no bright-lines rules. "Section 327(a) presents a per se bar to the appointment of a law firm with an actual conflict and gives the district court wide discretion in deciding whether to approve the appointment of a law firm with a potential conflict." In re Marvel Entertainment Group, Inc., 140 F.3d 463, 477 (3d Cir. 1998).

Disclosure, however, is essential in all cases. In *Leslie Fay*, for example, there were auditing irregularities, and the lawyer did not disclose that one of the directors on the audit committee was a senior officer at an investment bank that was a major client of the lawyer's firm. The court allowed the lawyer to continue its representation, but the court also found the lawyer violated Rule 2014. The court required the lawyer to pay for the costs of an examiner and other costs associated with the failure to disclose. In re Leslie Fay Companies, Inc., 175 B.R. 525, 539 (Bankr. S.D.N.Y. 1994).

In another case, a lawyer was sentenced to fifteen months in prison because he failed to disclose that his firm had represented a lender who was potentially subject to a fraudulent conveyance action. (Making matters worse, the lawyer also later lied about it.) It made no difference that the general creditors were being paid in full. See Milton C. Regan, Jr., Eat What You Kill: The Fall of a Wall Street Lawyer (2004).

There are any number of conflicts that might arise during a bankruptcy case. Conflicts counsel are routinely appointed in large cases, and this is often sufficient. "In many cases, the employment of conflicts counsel to handle issues where general bankruptcy counsel has an adverse interest solves most questions regarding the retention of general bankruptcy counsel." In re Project Orange Associates, LLC, 431 B.R. 363, 375 (Bankr. S.D.N.Y. 2010). Courts, however, draw the line when a creditor has a long-standing relationship with a law firm and sorting out that creditor's claim is central to the resolution of the case. As one court explained:

> How can counsel fairly and fully advise the [debtor] in negotiating with [one of its largest creditors] and in drafting a plan if [counsel is] unable, or at least unwilling, to espouse positions detrimental to the interests of [that creditor]? To ask the question would appear to supply a rather clear answer. In re Amdura Corp., 121 B.R. 862, 867 (Bankr. D. Colo. 1990).

In short, when actual conflicts exist with a lawyer, that lawyer cannot be retained, but potential conflicts that fall short of being actual conflicts and are not central to the case can often be navigated through a combination of conflict waivers, conflicts counsel, and other mechanisms.

Conflicts Encounters of the Third Kind

FTX, however, was different from past cases that involved fact-dense inquiries into whether a law firm could be counted to represent the debtor zealously. There was at least the possibility that the law firm's work would itself come under scrutiny as FTX's various misdeeds were unraveled. As a general matter, a law firm cannot represent a debtor if the bankruptcy itself will require scrutiny of the work that the law firm did prepetition. See In re Ressler Hardwoods & Flooring, Inc., 2010 WL 2342497 (Bankr. M.D. Pa. 2010). But what if it is not known at the outset of the case whether such scrutiny will be necessary?

On the one hand, much of the work by the law firm in *FTX* was relatively ordinary regulatory compliance and M&A work. These legal services, while expensive, were relatively generic. On its face, the work of the law firm seemed most unlikely to give rise to litigation against the law firm or require the participation of the law firm in any litigation. Statements made in various filings might turn out not to be true, but there was still no evidence that the law firm had any knowledge of bad behavior so saw any red flags that required further inquiry. The likely problems seemed ones that conflicts counsel could ordinarily handle.

But matters are necessarily complicated when there is massive wrongdoing. In these cases, a general fog lingers over the debtor. In the case of *FTX*, things were even worse than usual. In the words of FTX's own newly appointed CEO, the books and records of the firm were a "dumpster fire." There was no way to be sure that the law firm's own work would not come under major scrutiny once all the rocks were turned over.

Nor can one depend upon a newly appointed CEO to be sufficiently attentive to this problem, no matter how experienced or respected. A newly appointed CEO in cases like *FTX* is often put in place by the same law firm that wants to be debtor's counsel. It may not be realistic to expect that the new CEO's first act will be to displace the law firm that hired him.

In such cases, the judge should perhaps be particularly receptive when interested parties object to the debtor's choice of counsel. The judge might insist that the debtor suspected of engaging in fraud be represented by a law firm whose hands are unusually clean. There is something to be said for Caesar's wife being above suspicion.

Cases involving massive fraud, however, are overwhelmingly likely to be freefall bankruptcies. A leisurely process for finding debtor's counsel is not in the cards. Turning away able counsel who is already involved in the case may not be in the creditors' interest when there is only the possibility of the law firm's previous work later coming under scrutiny. It goes without saying, of course, that even if retention is permitted, disclosure must be unusually fulsome in these cases.