

Unethical Protection? Model Rule 1.8(h) and Plan Releases of Professional Liability

by

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INTRODUCTION

The American Bar Association's Model Rules of Professional Conduct address the propriety of attorneys obtaining releases from their clients of either past claims or future claims against themselves. Under the applicable Model Rule, both types of releases require the involvement, or the opportunity for involvement, of independent counsel to review and advise the client on the issue.

Releases in chapter 11 plans typically cover insiders, members of the creditors' committee, and the debtor's and committee's counsel. Few courts or disciplinary bodies of the various state bars have addressed the ethical issues that arise when counsel insert into a plan of reorganization a lengthy provision that releases counsel from all past claims and all future claims arising out of the chapter 11 case or the plan of reorganization.

This article examines the interaction of Model Rule 1.8(h) and plan release practice, concludes there is a conflict between practice and the Model Rule, and suggests a solution: making inclusion of a third-party release covering estate-compensated counsel an issue to be negotiated, reviewed, and approved as part of the process of retention of professionals early in the case, before parties rely on the availability of a release when rendering services. If the proper scope of a permissible release of professional liability is confronted early in the chapter 11 process, the Model Rule (or, more accurately, its locally-enacted analogue) can be complied with, and the effect of the release's availability or non-availability on fee structures and other elements of compensation can be made explicit.

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I. MODEL RULE 1.8(H) AND ITS VARIANTS

Model Rule of Professional Conduct 1.8(h) provides:

A lawyer shall not:

(1) make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement; or

(2) settle a claim or potential claim for such liability with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith.¹

It is important to note that the rule does not prohibit lawyers from entering into an agreement settling or releasing claims or possible claims of malpractice.² The rule does, however, recognize the lawyer's probable superior knowledge and bargaining power in this aspect of the attorney-client relationship, requiring that the client (1) be advised in writing that seeking independent counsel is prudent and (2) be given an opportunity to seek out that independent counsel.

All states have adopted Model Rule 1.8(h), its predecessor Disciplinary Rule 6-102,³ or a close variant of those rules.⁴ Some states appear absolutely

¹MODEL RULES OF PROF'L CONDUCT R. 1.8(h) (2007).

²MODEL RULES OF PROF'L CONDUCT R. 1.8 cmt. 15 (2007).

³MODEL CODE OF PROF'L RESPONSIBILITY DR 6-102(A) (1981); see also *id.* EC 6-6 ("A lawyer who handles the affairs of his client properly has no need to attempt to limit his liability for his professional activities and one who does not handle the affairs of his client properly should not be permitted to do so.").

⁴See ALA. RULES OF PROF'L CONDUCT R. 1.8(h); ALASKA RULES OF PROF'L CONDUCT R. 1.8(h); ARIZ. RULES OF PROF'L CONDUCT R. 1.8(h); ARK. RULES OF PROF'L CONDUCT R. 1.8(h); CAL. RULES OF PROF'L CONDUCT R. 3-400; COLO. RULES OF PROF'L CONDUCT R. 1.8(h); CONN. RULES OF PROF'L CONDUCT R. 1.8(h); DEL. RULES OF PROF'L CONDUCT R. 1.8(h); D.C. RULES OF PROF'L CONDUCT R. 1.8(g); FLA. RULES OF PROF'L CONDUCT R. 4-1.8(h); GA. RULES OF PROF'L CONDUCT R. 1.8(h); HAW. RULES OF PROF'L CONDUCT R. 1.8(h); IDAHO RULES OF PROF'L CONDUCT R. 1.8(h); ILL. RULES OF PROF'L CONDUCT R. 1.8(f); IND. RULES OF PROF'L CONDUCT R. 1.8(h); IOWA RULES OF PROF'L CONDUCT R. 32:1.8(h); KAN. RULES OF PROF'L CONDUCT R. 1.8(h); KY. RULES OF PROF'L CONDUCT R. 3.130(1.8(h)); LA. RULES OF PROF'L CONDUCT R. 1.8(h); ME. RULES OF PROF'L CONDUCT R. 1.8(h); MD. RULES OF PROF'L CONDUCT R. 1.8(h); MASS. RULES OF PROF'L CONDUCT R. 1.8(h); MICH. RULES OF PROF'L CONDUCT R. 1.8(h); MINN. RULES OF PROF'L CONDUCT R. 1.8(h); MISS. RULES OF PROF'L CONDUCT R. 1.8(h); MO. RULES OF PROF'L CONDUCT R. 4-1.8(h); MONT. RULES OF PROF'L CONDUCT R. 1.8(h); NEB. RULES OF PROF'L CONDUCT R. 3-501.8; NEV. RULES OF PROF'L CONDUCT R. 1.8(h); N.H. RULES OF PROF'L CONDUCT R. 1.8(h); N.J. RULES OF PROF'L CONDUCT R. 1.8(h); N.M. RULES OF PROF'L CONDUCT R. 16-108.H; N.Y. RULES OF PROF'L CONDUCT R. 1.8(h); N.C. REV. RULES OF PROF'L CONDUCT R. 1.8(h); N.D. RULES OF PROF'L CONDUCT R. 1.8(h); OHIO RULES OF PROF'L CONDUCT R. 1.8(h); OKLA. RULES OF PROF'L CONDUCT R. 1.8(h); OR. RULES OF PROF'L CONDUCT R. 1.8(h); PA. RULES OF PROF'L CONDUCT R. 1.8(h); R.I. RULES OF PROF'L CONDUCT R. 1.8(h); S.C. RULES OF PROF'L CONDUCT R. 1.8(h); S.D. RULES OF PROF'L CONDUCT R. 1.8(h); TENN. RULES OF PROF'L CONDUCT R. 1.8(h); TEX. RULES OF PROF'L CONDUCT 1.08(g); UTAH RULES OF PROF'L CONDUCT R. 1.8(h); VT.

to prohibit prospective waivers,⁵ while others allow them if the client is independently represented.⁶ Still others have enactments that are drafted ambiguously, most often due to confusion over which clause is modifying which provision.⁷ In some jurisdictions, it appears that, although the literal rule as adopted would absolutely prohibit prospective waivers of malpractice liability, the courts have interpreted the prohibition to be subject to exceptions.⁸

II. RELEASE AND INDEMNIFICATION PROVISIONS IN PLANS OF REORGANIZATION

In a chapter 11 case, the debtor's and the creditors committee's professionals often seek to limit or eliminate the risk of liability they may incur while employed in the case.⁹ These provisions are included in "third-party releases" or "plan releases." They appear as part of the plan the bankruptcy court confirms or as part of an order the court issues that eliminates liability and enjoins potential plaintiffs from initiating or continuing all or certain types of litigation related to a bankruptcy case against non-debtor third parties, such as the debtor's insiders¹⁰ and the debtor's accountants, lawyers, and other professionals. Although a release is a contractual term that one would not ordinarily expect to find in an order, bankruptcy court orders often incorporate by reference plans, loan agreements, sale agreements, and other documents that are attached as exhibits. In this sense, then, the order contains the release. It is also possible for a release to be inserted into proposed findings of fact and conclusions of law submitted to the court for consideration and entry.

RULES OF PROF'L CONDUCT 1.8(h); VA. RULES OF PROF'L CONDUCT R. 1.8(h); WASH. RULES OF PROF'L CONDUCT R. 1.8(h); W.VA. RULES OF PROF'L CONDUCT R. 1.8(h); WIS. RULES OF PROF'L CONDUCT R. 20:1.8(h); WYO. RULES OF PROF'L CONDUCT R. 1.8(h).

⁵See, e.g., Bar Ass'n of City of New York Comm. on Prof'l and Jud. Ethics, Formal Op. 1989-3 (1989).

⁶See, e.g., S.C. Ethics Advisory Comm., Adv. Op. 03-01 (2003) (allowing a prospective waiver of liability if the client is independently represented); Penn. Bar Ass'n Comm. on Legal Ethics & Prof'l Resp., Informal Op. No. 2004-24 (2004) (allowing a prospective waiver of liability if the client is independently represented); Or. St. Bar Ass'n, Formal Op. 2005-165 (2005) (allowing a prospective waiver of liability if the client is independently represented).

⁷See, e.g., *In re Winn-Dixie Stores, Inc.*, 356 B.R. 239, 261 (Bankr. M.D. Fla. 2006) (distinguishing the "retroactive" waiver of claims that occurs in a reorganization plan from a prospective waiver and settlement of claims and holding that "retroactive" waivers comply with Florida's version of rule 1.8); *In re Fazande*, 864 So. 2d 174, 180 (La. 2004) (noting that rule 1.8(h)(2) only applies to the settlement of a malpractice claim and does not require written notification before negotiation of a settlement).

⁸See, e.g., *In re LeBlanc*, 884 So. 2d 552, 557-58 (La. 2004) (holding that an attorney's unconditional tender of payment to a client with a malpractice claim, unaccompanied by a waiver, did not violate rule 1.8(h)).

⁹Ralph Brubaker, *Nondebtor Releases and Injunctions in Chapter 11: Revisiting Jurisdictional Precepts and the Forgotten Callaway v. Benton Case*, 72 AM. BANKR. L. J. 1, 2-4 (1998).

¹⁰11 U.S.C. § 101(31) defines "insider" and essentially focuses on identifying those in control of or in a position to control the debtor.

Third-party releases have not been accepted in all circuits, nor have they been unqualifiedly approved even when they have been accepted.¹¹ But in circuits where they are accepted, they have evolved from releases of entities, such as guarantors, co-liable with the debtor on prepetition obligations, to broad releases of directors, officers, and estate professionals from liability to the debtor, creditors, interest holders, and any number of other parties in interest for postpetition, and even postconfirmation, acts and omissions. A fairly typical third-party release provision might read:

Neither the Debtor, the Reorganized Debtor, the Creditors' Committee, nor any of their respective present members, officers, directors, employees, advisors, attorneys, agents, or other representatives shall have or incur any liability to any Creditor, Interest Holder or any other party in interest, or any of their respective agents, employees, representatives, financial advisors, attorneys, or affiliates, or any of their successors or assigns, for any act or omission in connection with, relating to or arising out of the chapter 11 Cases, the pursuit of confirmation of the Plan, the consummation of the Plan, or the administration of the Plan or the property to be distributed under the Plan, except for their willful misconduct, and in all respects shall be entitled to reasonably rely upon the advice of counsel with respect to their duties and responsibilities under the Plan.

Notwithstanding any other provision of this Plan, all Creditors, Interest Holders, other parties in interest, and any of their respective agents, employees, representatives, financial advisors, attorneys, or affiliates, and any successors or assigns of the foregoing or any professionals retained by them, shall have no right of action against the Debtor, the Reorganized Debtor, the Creditors' Committee, or any of their respective present or former members, officers, directors, employees, advisors, attorneys, or agents, for any act or omission in connection with, relating to or arising out of the chapter 11 Cases, the pursuit of confirmation of the Plan, the consummation of the Plan, or the administration of the Plan or the property to be distributed under the Plan, except for their willful misconduct, and each such Person is expressly enjoined from asserting or commencing any such action.

¹¹See GERALD L. BLANCHARD, *LENDER LIABILITY: LAW, PRACTICE AND PREVENTION*, § 12:42 (2d ed. 2007) (citing decisions that have invalidated plans of reorganization as violating 11 U.S.C. § 524(e) by discharging parties other than the debtor).

On the Effective Date, each of the Debtors and Reorganized Debtors shall be deemed to have settled, released and waived any and all claims, suits and/or causes of action of any nature whatsoever that any of the Debtors or Reorganized Debtors holds or might hold or assert against any officer, director, agent, employee, advisor, accountant or attorney of any Debtor serving in such capacity immediately prior to the Effective Date.¹²

This release is broad enough to trigger both subsections of Model Rule 1.8(h). It is both a prospective release - applying to claims "for any act or omission in connection with, relating to or arising out of the chapter 11 Cases, the pursuit of confirmation of the Plan, the consummation of the Plan, or the administration of the Plan or the property to be distributed under the Plan" - and a settlement of any existing claim or potential claim for such liability - "each of the Debtors and Reorganized Debtors shall be deemed to have settled, released and waived any and all claims . . . that any of the Debtors or Reorganized Debtors holds or might hold or assert against any . . . attorney." By releasing all claims "except for [those arising from] their willful misconduct," the release covers ordinary malpractice claims based on negligence, as well as claims based on gross negligence often not permitted under otherwise applicable non-bankruptcy law.¹³

A similar provision from a recent case demonstrates that the practice continues, arguably in a slightly more elaborate form, by splitting the provision between two release provisions and a defined term:

Exculpation and Limitation of Liability. Except as otherwise specifically provided in this Plan and the Plan Supplement, the Debtor, Reorganized RoomStore, the Creditors' Committee, the current and former members of the Creditors' Committee in their capacities as such, and any of such parties' respective present officers, directors, employees, advisors, attorneys, representatives, financial advisors, investment bankers, or agents and any of such parties' successors and assigns, shall not have or incur, and are hereby

¹²First Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code, *In re* APF, Co., No. 98-1596-PJW (Bankr. D. Del. May 27, 1999) (section of plan entitled "Exculpation and Limitation of Liability").

¹³The enforceability of pre-dispute waivers of negligence and gross negligence is beyond the scope of this article. In general, however, waivers of negligence in commercial transactions that do not implicate the public interest are valid, whereas waivers of gross negligence are often not. *See generally* RESTATEMENT (SECOND) OF TORTS § 496B (1965) ("A plaintiff who by contract or otherwise expressly agrees to accept a risk of harm arising from the defendant's negligent or reckless conduct cannot recover for such harm, unless the agreement is invalid as contrary to public policy").

released from, any claim, obligation, Cause of Action, or liability to one another or to any Claimholder or Inter-estholder, or any other party in interest, or any of their respective agents, employees, representatives, financial advisors, attorneys or Affiliates, or any of their successors or assigns, for any act or omission in connection with, relating to, or arising out of the filing the Chapter 11 Case, negotiation and filing of this Plan, the pursuit of confirmation of this Plan, the consummation of this Plan, the administration of this Plan or the property to be distributed under this Plan, except for their fraud, gross negligence or willful misconduct, and in all respects shall be entitled to reasonably rely upon the advice of counsel with respect to their duties and responsibilities under this Plan.¹⁴

This provision encompasses both claims that have arisen during the approximately five years that the case was pending pre-confirmation as well as those that might arise in the future during the "the consummation of this Plan, the administration of this Plan or the property to be distributed under this Plan."¹⁵ The plan in the case also contains another release:

Release by Debtor of Certain Parties. Pursuant to section 1123(b)(3) of the Bankruptcy Code, as of the Effective Date, the Debtor, in its individual capacity and as a debtor in possession for and on behalf of its Estate, shall release and discharge and be deemed to have conclusively, absolutely, unconditionally, irrevocably and forever released, waived and discharged all Released Parties for and from any and all claims, obligations, rights, Causes of Action, and liabilities, existing as of the Effective Date in any manner arising from, based on or relating to, in whole or in part, the Debtor, the subject matter of, or the transactions or events giving rise to, any Claim or Interest that is treated in this Plan, the busi-

¹⁴Amended and Restated Joint Plan of Reorganization Proposed by HMY Roomstore, Inc. and the Official Committee of Unsecured Creditors § 10.4, *In re Heilig-Meyers Co.*, No. 00-34533-DOT (Bankr. E.D. Va. March 9, 2005) (Docket No. 5843). The *Heilig-Meyers* plan was incorporated by reference into the order confirming the plan, which is really a combination of findings of fact, conclusions of law, and an order confirming the plan. See Order of Confirmation at 25, § D(4), *In re Heilig-Meyers Co.*, No. 00-34533-DOT (Bankr. E.D. Va. May 18, 2005) (Docket No. 6047). While incorporation of the plan into the confirmation order, findings, and conclusions is not the practice in all jurisdictions, in the author's experience it is not at all uncommon.

¹⁵Amended and Restated Joint Plan of Reorganization Proposed by HMY Roomstore, Inc. and the Official Committee of Unsecured Creditors § 10.4, *In re Heilig-Meyers Co.*, No. 00-34533 (Bankr. E.D. Va. March 9, 2005) (Docket No. 5843).

ness or contractual arrangements between the Debtor or any Released Party, the restructuring of Claims and Interests prior to or in the Chapter 11 Case, or any act, omission, occurrence or event in any manner related to any such Claims, Interests, restructuring or the Chapter 11 Case. Reorganized RoomStore shall be bound, to the same extent the Debtor is bound, by all of the releases set forth above.¹⁶

This second release requires that one look to the definition of the term "Released Parties" to see that it also covers the debtor's and the committee's counsel, supplementing the protections of the prior release provision in a "belt and suspenders" fashion:

"Released Parties" means, collectively, (i) all officers, directors, employees, consultants, agents, financial advisors, attorneys and other representatives of the Debtor which served in such capacities on and subsequent to the Petition Date; (ii) the Creditors' Committee, including its agents, financial advisors, and attorneys in their capacities as such, and all current and former members of the Creditors' Committee in their capacities as such; and (iii) with respect to each of the above-named Persons, such Person's affiliates, principals, employees, agents, officers, directors, financial advisors, attorneys and other professionals, in their capacities as such.¹⁷

These releases have become a staple of reorganization practice and may even be evolving into broad indemnification provisions that shift the burden of paying for enforcing the release from the insiders and professionals to the debtor or the estate.¹⁸

III. CONFLICT BETWEEN THE MODEL RULE AND REORGANIZATION PRACTICE

A plan of reorganization is a collective contract between the debtor, its estate, its creditors, its interest holders, its administrative and other priority claimants, and other parties in interest.¹⁹ When the plan, usually drafted by

¹⁶*Id.* at § 10.5.

¹⁷*Id.* at § 1.89.

¹⁸*See, e.g.,* Unsecured Creditors' Committee v. Pelofsky (*In re* Thermadyne Holdings Corp.), 283 B.R. 749, 756-57 (B.A.P. 8th Cir. 2002) (upholding bankruptcy court's disapproval of such a provision but emphasizing there is no per se prohibition on such provisions which should be subjected to a determination of their reasonableness on a case-by-case basis).

¹⁹It is necessary to differentiate between creditors and claimants due to the definitional structure of the bankruptcy code. "Creditors" are entities that hold claims arising or deemed to arise prior to the

the debtor's attorneys, includes a release like the ones set out above, it runs squarely up against Model Rule 1.8. Yet the problem appears to have been all but ignored in practice, and the decisions citing Model Rule 1.8 do not address the rule's applicability in chapter 11 cases. No evidence suggests that debtors are told to seek independent counsel to advise them on whether a release should be included, and if so, at what cost to the attorneys involved. This section of the article explores whether federal bankruptcy law preempts or precludes²⁰ Model Rule 1.8, and if not, what the consequences of a viola-

petition date. 11 U.S.C. § 101(10) (2007). They are thus a subset of claimants, a group that includes holders of claims arising both prepetition and postpetition.

²⁰*Preemption" is generally the concept that a valid federal law on a subject will displace state law on a subject if Congress intended to "occupy the field" or if state law conflicts with the federal law. See *Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 372 (2000); see, e.g., also *In re John Richards Homes Building Co.*, 298 B.R. 591, 594 (Bankr. E.D. Mich. 2003) (concluding that 11 U.S.C. § 303(i) preempts Florida homestead law allowing a debtor against whom an involuntary case had been filed in bad faith to reach the wrongfully petitioning creditor's otherwise exempt home); *Graber v. Fuqua*, 279 S.W.3d 608, 612 (Tex. 2009) (presenting an implied preemption analysis based upon two categories or types of bankruptcy laws—(a) those that were "custom-built" for bankruptcy like 11 U.S.C. §§ 301 (voluntary petitions), 302 (involuntary petitions), 362 (automatic stay) and (b) those that were merely imported from general federal law such as the 7000-series of the Federal Rules of Bankruptcy Procedure—and noting that where bankruptcy law is custom-built, "preemption is more likely because when Congress crafted new, unique provisions, it probably contemplated whether or not to exclude overlapping state law remedial schemes").

Claim or issue preclusion is generally the result of a court determination by order or judgment that precludes a party from seeking contrary relief in that court or another forum. Claim preclusion is addressed through the doctrine of *res judicata*. See *Taylor v. Sturgell*, ___ U.S. ___, 128 S. Ct. 2161, 2171 n.5 (2008) ("The preclusive effect of a judgment is defined by claim preclusion and issue preclusion, which are collectively referred to as 'res judicata.' Under the doctrine of claim preclusion, a final judgment forecloses successive litigation of the very same claim, whether or not relitigation of the claim raises the same issues as the earlier suit. Issue preclusion, in contrast, bars successive litigation of an issue of fact or law actually litigated and resolved in a valid court determination essential to the prior judgment, even if the issue recurs in the context of a different claim. By preclud[ing] parties from contesting matters that they have had a full and fair opportunity to litigate, these two doctrines protect against the expense and vexation attending multiple lawsuits, conserv[e] judicial resources, and foste[r] reliance on judicial action by minimizing the possibility of inconsistent decisions.") (internal citations and quotations omitted).

Interestingly, however, in the bankruptcy context, the terms "preemption" and "preclusion" have become somewhat confused or conflated, perhaps due to the interaction of the bankruptcy court's order confirming the plan, the plan itself, and Code sections 1123(a)(5) and 1142(a). See *Pacific Gas & Electric Co. v. Cal. ex rel Cal. Dep't of Toxic Substances Control*, 350 F.3d 932, 937 (9th Cir. 2003) ("We hold that a reorganization plan proposed under § 1123(a)(5) expressly preempts otherwise applicable non-bankruptcy laws only to the extent that such laws were already preempted before the addition of the 'notwithstanding' clause to § 1123(a) by amendment in 1984. That is, we hold that the addition of the 'notwithstanding' clause to § 1123(a) was merely a clarification and confirmation of the preemptive effect of a reorganization plan that already existed under the 1978 Bankruptcy Code. That preemptive effect, expressly stated in the 'notwithstanding' clause of § 1142(a), was limited to otherwise applicable nonbankruptcy laws 'relating to financial condition.');" *In re Pub. Serv. Co.*, 108 B.R. 854, 882 (Bankr. D.N.H. 1989), *vacated as moot*, June 28, 1991 (holding that 11 U.S.C. § 1123(a)(5) broadly and expressly causes plan terms to preempt otherwise applicable non-bankruptcy law).

The distinction between preemption or claim preclusion in the context of plan releases of professionals is a distinction without a difference, however. Whether a court finds either that the release in the plan,

tion of the rule would be. It sets the stage for section IV's suggested solution: disclosure of the possibility of such a release when counsel is retained, and if one is included in the plan, again when the disclosure statement is approved and the plan confirmed to determine if the release is reasonably necessary, if the release has been adequately explained to the client, and if the client has been given the opportunity to seek independent counsel regarding the release's inclusion in the plan.

A. THE EFFECT OF PREEMPTION OR CLAIM PRECLUSION ON RULE 1.8'S LOCAL VARIANT

Because bankruptcy courts at least implicitly²¹ approve releases when plans containing them are confirmed, once those orders are final, the releases arguably preempt or preclude state law in the field of bankruptcy.²² This is an attractive position to those favoring a broadly preemptive approach to bankruptcy, but one that probably goes too far. After all, federal courts retain the right to admit attorneys to practice before them but generally leave licensure and discipline of lawyers to the states.²³ A broad preemptive approach would fundamentally undermine this system. Presumably, then, while the confirmation order might bar malpractice claims against counsel, it would not bar state disciplinary proceedings against them. In other words, release of the claim does not necessarily cure the violation of the ethical rule or block disciplinary action for improper actions taken to obtain the release.²⁴

through the confirmation order and sections 1123(a)(5) and 1142(a), preempts applicable nonbankruptcy law that would otherwise support a plaintiff's claims, or that the plaintiff's claims have been precluded by the terms of the plan, the plaintiff is still left without a claim to prosecute, and the professional is still left with a defense to the claim based upon the release.

²¹See *supra* notes 9-18 and accompanying text.

²²Philip Blumberg, *The Continuity of the Enterprise Doctrine: Corporate Successorship in United States Law*, 10 FLA. J. INT'L L. 365, 415 (1996) (discussing preemption in the context of successor liability and plan injunctions purporting to bar such claims and stating that "the bankruptcy law generally preempts state law insofar as implementation of plans of reorganization and other post-petition judicially approved dispositions of the debtor's assets are conceived.")

²³See Thomas D. Morgan, *It's Not Perfect, but the ABA Does a Key Job in State-Based Regulation of Lawyers*, 11 TEX. REV. L. & POL. 381, 381 (2007); Nancy B. Rapoport, *The Intractable Problem of Bankruptcy Ethics: Square Peg, Round Hole*, 11 J. BANKR. L. & PRAC. 391, 398 (2002); Larry D. Thompson, *The McDade Law: Necessary for Justice or a Burden for Federal Attorneys?*, FED. LAW. Jan. 2001 at 20, 22 (2001).

²⁴But see *Pertuso v. Ford Motor Credit Co.*, 233 F.3d 417 (6th Cir. 2000). In *Pertuso*, the debtors claimed that the discharge injunction had been violated and sought to pursue state law unjust enrichment and accounting causes of action. The court conducted an implied preemption analysis and found that allowing the debtors to assert "a host of state law causes of action to redress wrongs under the Bankruptcy Code would undermine the uniformity the Code endeavors to preserve and would stand as an obstacle to the accomplishments and execution of the full purposes and objectives of Congress." *Id.* at 426 (internal quotations and citations omitted); See also *Joubert v. ABN AMRO Mortgage Group, Inc. (In re Joubert)*, 411 F.3d 452, 456 (3d Cir. 2005) (questioning whether the Bankruptcy Code creates implied private causes of action).

If a plan of reorganization does not preempt or preclude actions under the local analogue of Model Rule 1.8—rather than under applicable non-bankruptcy law regarding professional malpractice—then what is the result of the rule's violation? First, although the practice of including these releases in plans is widespread, there has apparently been little or no action on the part of disciplinary officials to examine or address the practice.²⁵ Second, few, if any, bankruptcy attorneys or judges refer the act of proposing or adopting such releases to the various states' disciplinary authorities.²⁶ Because every attorney appearing in a bankruptcy case holds at least one state bar license, why don't these attorneys recognize the prohibition of releases obtained in violation of an attorney's ethical obligations? The problem, then, is not only that these releases are inserted into plans of reorganization without regard for the rules of professional conduct, but also that nobody involved apparently recognizes the ethical implications and violations.

B. THE EFFECT OF THE RELEASE ON A MALPRACTICE PLAINTIFF'S CLAIM

An order confirming a plan is no longer subject to appeal once ten days have passed after its entry.²⁷ At that point the order can only be revoked within 180 days and on the ground that the order was procured by fraud.²⁸ This limitation is strictly construed and applied.²⁹ So, in other words, eleven days after confirmation, the confirmation order and any release constitute a final order entitled to full faith and credit, and on the 181st day after entry, the confirmation order and release can no longer be revoked by the bankruptcy court. Arguably, applying the literal meaning of these plan releases, malpractice claims against covered professionals paid by the estate are barred as of the confirmation date or effective date of the plan, whether or not the professionals' final fee applications have been granted. It is doubtful that a bankruptcy court would adopt this interpretation. It is far more likely that the plan will be seen as part of the larger chapter 11 case, as are the final fee applications, which are referenced in many plans in order to comply with the

²⁵Most but not all federal courts apply the rules of professional conduct of the state in which they sit. See Judith A. McMorrow, *The (F)utility of Rules: Regulating Attorney Conduct in Federal Court Practice*, 58 SMU L. REV. 3, 10-11 (2005).

²⁶The author has never heard of such a report or referral ever being made in this context and his research has not found any examples.

²⁷Fed. R. Bankr. P. 8002(a).

²⁸11 U.S.C. § 1144.

²⁹*Mickowski v. Visi-Trak Worldwide, LLC*, 415 F.3d 501, 508 (6th Cir. 2005) (holding that under 11 U.S.C. § 1144 an order of confirmation cannot be revoked absent a showing of fraud in obtaining the confirmation order itself); *In re Errington*, 39 B.R. 968, 971 (Bankr. D. Minn. 1984) (holding that 11 U.S.C. § 1144 is the exclusive method Congress provided for the revocation of an order of confirmation); *First State Bank & Trust Co. v. Bishop (In re Bishop)*, 74 B.R. 677, 680 (Bankr. M.D. Ga. 1987).

requirements of 11 U.S.C. § 1129(a)(4).³⁰ The more likely interpretation, then, would lead to claim preclusion barring claims of malpractice only after a final fee application has been approved.³¹ It is unclear whether, if a plan release has been approved and is effective, relief at the final fee application stage is limited to denial of the fees involved, or if affirmative relief in terms of a money damage award against the professional is also possible. That issue is beyond the scope of this article.

³⁰11 U.S.C. § 1129(a)(4) declares that the court cannot confirm a plan unless:

Any payment made or to be made by the proponent, by the debtor, or by a person issuing securities or acquiring property under the plan, for services or for costs and expenses in or in connection with the case, or in connection with the plan and incident to the case, has been approved by, or is subject to the approval of, the court as reasonable.

³¹Claim preclusion (*res judicata*) prevents parties from litigating the same case more than once. Under federal law, the doctrine has three elements: (1) a final judgment on the merits, (2) an identity of the causes of action, and (3) an identity of the parties or their privies. *Golden v. Barenborg*, 53 F.3d 866, 869 (7th Cir. 1995). The defendant must raise the defense and has the burden of proving all of the elements. See, e.g., *Osherow v. Ernst & Young, LLP (In re Intelogic Trace, Inc.)*, 200 F.3d 382, 386 (5th Cir. 2000) (citing *Nilson v. City of Moss Point*, 701 F.2d 556, 559 (5th Cir. 1983); *Stangel v. Perkins*, 87 S.W.3d 706, 710 (Tex. Ct. App. 2002) (citing *Intelogic Trace* for the federal requirements). After a final fee application is approved, the elements for a claim preclusion defense in a subsequent malpractice action will typically be met. See, e.g., *Iannochino v. Rodolakis (In re Iannochino)*, 242 F.3d 36, 44 (1st Cir. 2001). Issue preclusion (*collateral estoppel*), in contrast, requires that (1) the issue at stake must be identical to the one involved in the prior action, (2) the issue must have been actually litigated in the prior action, and (3) the determination of the issue in the prior action must have been a part of the judgment in that earlier action. *Id.*

In *Iannochino*, for example, the court held that the chapter 7 debtors' action for malpractice against their former attorney was barred by *res judicata*, because the bankruptcy court had previously awarded attorney's fees that the debtors had disputed. The court stated that:

the bankruptcy court must undertake a comprehensive evaluation of the services listed in a fee application when determining whether to award fees. Under section 330, the bankruptcy court must consider "the nature, the extent, and the value of such services." A bankruptcy court therefore makes an implied 'finding of quality and value' in the professional services provided to the Iannochinos during the bankruptcy.

Id. at 46 (internal citations and quotations omitted). For similar, oft-cited cases, see *Grausz v. Englander*, 321 F.3d 467 (4th Cir. 2003), and *Shaw v. Replogle (In re Shaw)*, Nos. C 00-2820 CRB, 98-3-1299-DM, 99-3-0401-TC, 2000 WL 1897344 (N.D. Cal. Dec. 22, 2000). See also *Intelogic Trace*, 200 F.3d at 389 (noting that while the debtor's board of directors "may not have been aware of all the precise facts or reached a firm conclusion," the board's documented concerns were sufficient to give rise to *res judicata*); *Indus. Clearinghouse, Inc. v. Mims (In re Coastal Plains, Inc.)*, 338 B.R. 703, 715 (N.D. Tex. 2006) (holding breach of fiduciary duty claims against trustee barred by *res judicata* effect of final fee application approval, although the debtors did not contest the fee application, and stating that "the law of the Fifth Circuit does not require a party to have understood the legal implications of the facts giving rise to a claim in order for the claim to be barred by *res judicata*"); but see *Pipkin v. Henry & Peters, P.C. (In re R & C Petroleum, Inc.)*, 236 B.R. 355, 359-60 (Bankr. E.D. Tex. 1999) (noting that when plaintiffs only learn of the malpractice after the bankruptcy court has approved a fee application, the action will not be barred); *Brunacini v. Kavanaugh*, 869 P.2d 821, 827 (N.M. Ct. App. 1993) (finding that a claim for legal malpractice is not subject to *res judicata* because the claim is tolled during the pendency of an appeal from the fee award).

IV. A SOLUTION: DISCLOSURE AND APPROVAL AT THE TIME OF RETENTION

Model Rule 1.8(h) and its local analogues generally prohibit attorneys from obtaining releases of either past claims or future claims against themselves from their clients. Under the Rule, both types of releases require the involvement, or at least the opportunity for involvement, of independent counsel to review and advise the client on the issue.

But chapter 11 debtors' counsel are inserting provisions releasing themselves and committee counsel from past and future claims in plans of reorganization. These releases appear to be binding under either a preemption or preclusion analysis even if they violate the ethical rule. This is true not only because of the preemptive or preclusive effect of a final, unappealed plan confirmation order but also because of the preclusive effect of an order granting a final fee award to counsel. Yet many federal courts employ their own disciplinary rules identical or similar to the disciplinary rules of the state in which they sit, including provisions like Model Rule 1.8(h).

How then to address both the practice of gaining these releases and addressing compliance with Model Rule 1.8(h)? One answer: disclosure early in the process as part of the hearing on retention of counsel, as well as repeated disclosure during the disclosure statement and plan confirmation process.

Debtor's and committee counsel's retention and the terms of retention must be approved by the court at the inception of the post-petition representation if they are to be paid from the estate.³² Typically, and prudently, counsel in these situations use a retention agreement, often in the form of a letter, outlining the terms of the representation. The key terms are typically presented to the court in the application to employ, to which the full retention agreement is often attached. If a retention agreement features an indemnity provision, prudent professionals disclose it in the retention agreement and employment application.³³ Because a plan release has a similar liability-limiting (or eliminating) role, counsel should disclose it and negotiate whether it is appropriate at the time of employment.

Professionals arguing for releases at plan confirmation may claim they need them in order to take on the representation. But courts should be skeptical about these assertions. No case has been identified where, faced with the lack of a plan release, counsel has countered with a demand for higher

³²11 U.S.C. § 327.

³³See, e.g., *Unsecured Creditors' Committee v. Pelofsky (In re Thermadyne Holdings Corp.)*, 283 B.R. 749, 752 (B.A.P. 8th Cir. 2002). The inclusion of indemnity provisions for estate professionals is a fairly recent development and stands at odds with the traditional rule of practice in much of the country: debtors do not indemnify. Exploration of the evolution of indemnity provisions in retention agreements, plans of reorganization, and other bankruptcy transactional documents is beyond the scope of this article.

fees. Nor is there a reported decision reflecting discounted attorneys' fees based on the availability of a limitation or elimination-of-liability provision in a plan.³⁴

When independent counsel does review a proposed release, they should consider whether the waiver might cause counsel seeking it to be sloppier about their work. After all, the original reason for prohibiting such releases was to prevent lawyers from doing less-than-adequate work and asking their clients to forgive the inadequacy.³⁵ Counsel should also consider what independent consideration, such as decreased fees or other preferred billing practices, might be extended to a debtor willing to commit to release of professional liability claims in and arising out of the successful³⁶ chapter 11 case.

CONCLUSION

The conflict between Model Rule of Professional Conduct 1.8(h) and modern third-party release practice in chapter 11 cases has been largely ignored by courts and case law. Current practice lends preemptive or claim preclusive effect to bankruptcy court orders confirming plans containing these releases, and enforcement of these releases runs counter to the disciplinary and ethical functions of state disciplinary authorities. Full disclosure of the potential for such a release early in the case as part of the process of retaining professionals can alleviate the problem, allowing considered analysis of the appropriateness of broad plan releases sheltering professionals from malpractice and other liability.

³⁴The cost of malpractice coverage is presumably already bundled into professional fees, along with other overhead such as office rent, non-billing support staff, computers, and other equipment. But if professionals can show the need for the proposed release, it could be approved at the employment stage of the case, or approval could be reserved for later, and the debtor (or creditors' committee) can be advised to seek independent counsel to review the form and substance of the release and whether it is appropriate to have such a provision in the plan. Of course, the retention of independent counsel to advise the debtor regarding the release who will be paid from the estate would first require court approval, in accordance with 11 U.S.C. § 327.

³⁵Comment 14 to Model Rule 1.8 begins: "Agreements prospectively limiting a lawyer's liability for malpractice are prohibited unless the client is independently represented in making the agreement because they are likely to undermine competent and diligent representation." MODEL RULES OF PROF'L CONDUCT R. 1.8 cmt. 14 (2007).

³⁶Successful in the sense that a plan of some sort is confirmed, as that is the document in which the releases described in this article are found. There are certainly other measures of success in chapter 11, including settlement with critical creditors and dismissal of the case or the preservation of a business through a sale of substantially all of its assets as a going concern under 11 U.S.C. § 363(b) and (f). These other forms of success and the possibility that a release of professional liability could be validly included in the relevant transactional documents or court orders are beyond the scope of this article.