

**Where the Wild Things Are:
An Update of Recent “Ethical” Decisions**

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Where the Wild Things Are: An Update of Recent “Ethical” Decisions

This paper is designed to provide a brief update of recent decisions of note that concern various ethical issues bankruptcy attorneys often encounter, focusing on conflicts of interest and privilege issues. Additionally, this paper will address recent Supreme Court decisions concerning bankruptcy law including the *Espinosa* decision (concerning plan confirmation issues) and the *Milavetz* decision (dealing with the definition of “debt relief agencies” under the Bankruptcy Code).

RECENT SUPREME COURT CASES

U.S. Aid Funds, Inc. v. Espinosa, 559 U.S. ____ (2010).

The Effect of a Confirmed Plan

A number of courts have held that a confirmed plan is *res judicata* as to all creditors and parties-in-interest with notice of the confirmation proceedings, whether or not the provisions in that plan comply with the Code or other applicable law, including the Supreme Court in *Stoll* and the Fifth Circuit in *Shoaf*.³ In light of this doctrine, lawyers are tempted to include any number of favorable provisions in a proposed plan, even if those provisions may not comply with the letter of the law.

Zealous representation of one’s client, some might argue, would actually *require* an attorney to include these favorable provisions in a plan.⁴ After all, as long as the plan is properly noticed, creditors will have every opportunity to review the plan, spot any objectionable provisions, and raise the necessary objections. Plans are often seen as contracts between the debtor and its creditors, and a creditor’s silence presumably means that the provisions in question – though perhaps not permissible if litigated – are acceptable to the creditor in exchange for its treatment under the plan.

Several courts have struggled with this strategy, however. As noted by the Bankruptcy Court for the Northern District of Iowa in *In re Mammel*:

This constitutes a trap for unwary creditors. . . . Ultimately, this type of provision trivializes the entire process and reduces it to a game of chance. If Debtor can obtain confirmation before the creditors, the Court, or the Trustee identify such a provision, the objectionable plan provision is elevated to a status beyond challenge.⁵

This trap often arises in the context of Chapter 13 plans that purport to discharge student loan debt despite the provisions of §§ 1328(a)(2) and 523(a)(8), and without the procedural steps required by Bankruptcy Rule 7001(6). The Supreme Court’s recent decision in *Espinosa*, while affirming the finality of a confirmed plan and the doctrine of *Stoll*, *Shoaf*, and other similar cases, raises doubts as to the propriety of this strategy and provides guidance to courts and attorneys as to the proper remedies for – and consequences of – such an approach.

Espinosa – *Stoll* and *Shoaf* Affirmed

In *Espinosa*, the debtor’s Chapter 13 plan proposed to pay off the principal amounts of his student loan debt over time, and provided that the balance (the accrued interest) would be discharged upon completion of

³ *Stoll v. Gottlieb*, 305 U.S. 165, 59 S. Ct. 134 (1938); *Anderson v. UNIPAC-NEBHELP (In re Anderson)*, 179 F.3d 1253 (10th Cir. 1999); *In re Pardee*, 193 F.3d 1083 (9th Cir. 1999); *Republic Supply Co. v. Shoaf*, 815 F.2d 1046 (5th Cir. 1987).

⁴ See, e.g., *In re Hensley*, 249 B.R. 318, 321 (Bankr. W.D. Okla. 2000) (“[C]ounsel . . . suggest that they are compelled by *Anderson* to recommend that their clients include these unlawful plan provisions, implying that their failure to do so might be an act of professional negligence.”).

⁵ *In re Mammel*, 221 B.R. 238, 243 (Bankr. N.D. Iowa 1998).

these payments. Espinosa provided actual notice of the provision to the lender (United), who did not object to the wording of the plan. Instead, United filed a proof of claim including amounts for both principal and interest. Following confirmation – which was obtained without holding the required adversary proceeding to determine undue hardship – the Chapter 13 trustee again provided actual notice to United, noting that the amount in its proof of claim was different from that proposed to be paid under the plan, and advising United to notify the trustee within 30 days of any dispute. Again, United took no action.

Following collection attempts by the Department of Education after completion of his plan payments, Espinosa requested that the bankruptcy court find that the remainder of his student loans were discharged. The bankruptcy court agreed, the district court reversed on due process grounds, and the Ninth Circuit reversed the district court and upheld the bankruptcy court. United then appealed to the Supreme Court.

The Supreme Court’s opinion affirmed the Ninth Circuit and the bankruptcy court’s ruling. In keeping with the *Stoll* and *Shoaf* line of cases, the Supreme Court held that Espinosa complied with the requirements of due process by providing actual notice to United and that the legal error committed by confirming the plan despite its failure to comply with §§ 1328(a)(2) and 523(a)(8) was insufficient to overturn the confirmation order under Rule 60(b).

Ultimately, therefore, Espinosa’s attorney’s strategy was rewarded – by including the clearly improper student loan discharge language in the plan, Espinosa was able to obtain a discharge of his student loan debt without proving undue hardship and without commencing an adversary proceeding against United. Clearly, this depended on a stroke of good luck in the form of United’s inattention to Espinosa’s plan and to proper procedure, but, as the *Mammel* court noted, all Espinosa and his attorney risked was the possibility of modification of the plan or the trouble of complying with the Code provisions regarding student loan discharge – which is no more than would have been required if they had not attempted to include this language in the plan in the first place.

Valid Strategy, or Invitation to Sanctions?

Espinosa acknowledged this temptation, however, and went further than simply enforcing the terms of the confirmation order. As can be seen from the transcript of oral argument in *Espinosa*,⁶ a number of the justices believed that the strategy employed by Espinosa and his attorney violated the guidelines contained in Rule 11. This is echoed in the *Espinosa* opinion itself:

As we stated in *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992) [enforcing exemptions beyond that permitted by the Code, where no party-in-interest timely objects], ‘debtors and their attorneys face penalties under various provisions for engaging in improper conduct in bankruptcy proceedings,’ *id.* at 644; *see* Fed. Rule Bkrcty. Proc. 9011. The specter of such penalties should deter bad-faith attempts to discharge student loan debt without the undue hardship finding Congress required. And to the extent existing sanctions prove inadequate to this task, Congress may enact additional provisions to address the difficulties United predicts will follow our decision.⁷

As was noted by counsel during oral argument, it is difficult to find any court that has actually enforced Rule 11 sanctions for including an impermissible provision in a plan. The Bankruptcy Court for the Southern District of Ohio perhaps came the closest in *In re Evans*, 242 B.R. 407 (Bankr. S.D. Ohio 1999), expressing its doubt that reliance on cases such as *Anderson* and *Pardee* serves as a basis under Rule 11 for an otherwise unsupported plan provision.⁸ The *Evans* court, which raised the impermissibility of a student loan “discharge by

⁶ Relevant excerpts attached in the Appendix to this paper.

⁷ *Espinosa*, 559 U.S. ____ at *17.

⁸ *Id.* at 412.

declaration” *sua sponte*, ultimately denied confirmation of the plan and issued a show cause order to the debtor’s attorney to demonstrate why sanctions under Rule 11 were not merited.⁹ A review of the docket, however, indicates that sanctions were ultimately not issued, following consideration of briefing and affidavits from the debtor’s attorney. *Espinosa* leaves open the possibility of – and perhaps even encourages – courts to go further than the *Evans* court and impose Rule 11 sanctions to curtail these strategies.

Espinosa not only serves as a warning to debtors and their attorneys, but contains an admonition to judges as well. The Ninth Circuit stated that courts *must* confirm plans that contain objectionable provisions (specifically, student loan discharges without a determination of undue hardship) as long as there have been no objections by parties-in-interest. The Supreme Court viewed this as a “step too far,” and emphasized the requirement of § 1325(a) that a plan comply with the applicable provisions of the Code. In light of this section, the *Espinosa* court held, it is not only within a bankruptcy court’s authority to deny such an objectionable plan, but is also its *obligation*.¹⁰

Open Issues

So where does *Espinosa* leave the “discharge by disclosure” strategy? Clearly it raises the possibility of Rule 11 sanctions issuing to address unsupportable plan provisions. It is unclear, however, whether courts will issue sanctions outside the most unquestionable situations – Rule 11, after all, permits attorneys to raise issues supported by a “nonfrivolous argument for extending, modifying, or reversing existing law or for establishing new law.” Attorneys should not be afraid to challenge existing precedent in good faith, and should not face sanctions for doing so. Do commonly included plan provisions such as the discharge of setoff or recoupment rights or the release of third parties rise to the level of Rule 11 sanctions?

Should there be a greater level of disclosure by attorneys if questionable provisions are included in a plan? Many Chapter 11 plans, for example, can be hundreds of pages long, providing ample opportunity to sneak in a questionable provision and strong disincentive for the average creditor to spend the legal fees and time needed to hunt through the document, find these provisions, and file an objection – especially if the provision doesn’t appear likely to directly affect the creditor’s rights. Do attorneys therefore have a responsibility to point out potential disputes in a confirmation brief or otherwise – and how does that affect their duties as zealous advocates of their clients?

Must courts likewise search through plans with a fine-toothed comb, in light of the Supreme Court’s statement that it is their *obligation* to deny confirmation of any improper plan? Is this obligation changed if the plan was heavily negotiated by the major constituents of the debtor’s estate? As noted in *Espinosa*, there is nothing preventing a creditor from knowingly waiving what would otherwise be its rights under the Code, but the bankruptcy court must still “make an independent determination of undue hardship before a plan is confirmed.”¹¹ Should a similar requirement apply to all negotiated plan provisions?

Perhaps an appropriate remedy for a blatant attempt to slip an improper plan provision by the court and the creditors is to deny confirmation of the plan and, in the case of a Chapter 11 plan, terminate exclusivity or appoint a trustee. In addition, the court can take into consideration come fee application time the attempts by the attorneys to circumvent the Bankruptcy Code.

Practice Tip:

Whatever the answers to the questions raised above, it is clear that attorneys engaging in the “discharge by declaration” tactic should strongly consider the effect of *Espinosa* before filing their next plan. Similarly,

⁹ *Id.* at 409, 413.

¹⁰ *Espinosa*, 559 U.S. at *15.

¹¹ *Espinosa*, 559 U.S. at *16.

attorneys should review the forms used as a starting point in drafting plans with an eye toward eliminating or modifying questionable “boilerplate” provisions. While continued use of these provisions may still result in a lucky – and perhaps undeserved – win on occasion, *Espinosa* suggests that there may be more at risk than the relatively minimal time and expense needed to redraft the plan if the provision doesn’t slip through the cracks.

***Milavetz, Gallop & Milavetz v. United States*, ___ S.Ct. ___, 2010 WL 757616 (2010)**

Do Attorneys Qualify as “Debt Relief Agencies?” More importantly, is that a problem?

Under the plain language of § 101(12A), as amended by BAPCPA, attorneys assisting in consumer bankruptcy preparation appear to qualify as a “debt relief agency” – a person “who provides any bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration, or who is a bankruptcy petition preparer.” Standing alone, the scope of the definition seems clear. Section 526(a)(4), however, prohibits debt relief agencies from “advis[ing] an assisted person to incur more debt in contemplation” of filing bankruptcy. Further, § 528 mandates a number of disclosures by debt relief agencies in their advertisements, such as the mandatory inclusion of the following: “We are a debt relief agency. We help people file for bankruptcy relief under the Bankruptcy Code.” These provisions raised First Amendment concerns for many attorneys, as they respectively restrict and mandate certain categories of speech of debt relief agencies. If the provisions meant what they appeared to say, attorneys could – among other things – face civil liability for the content of their advice to prospective debtors.

The response to these amendments was swift – on the effective date of BAPCPA Judge Davis of the United States Bankruptcy Court for the Southern District of Georgia entered an order *sua sponte* holding that attorneys are not debt relief agencies for purposes of § 101(12A), thus avoiding the need for a constitutional analysis of the related provisions.¹² These issues were then raised and addressed by other courts, ultimately leading to a split among the Circuits as to the scope of § 101(12A) and the constitutionality of the related provisions. This left attorneys without definitive guidance as to the scope of these provisions and the level of risk involved in failing to comply with the restrictions and guidelines therein. Eventually the Supreme Court granted *certiorari* on the issue, taking an appeal from a ruling of the Eighth Circuit that held that attorneys are debt relief agencies and that the related provisions (limiting the scope of advice and mandating certain disclosures) are unconstitutional violations of attorneys’ First Amendment rights to free speech.

Yes, Attorneys are Debt Relief Agencies, too

The Supreme Court ultimately held that attorneys are debt relief agencies for purposes of § 101(12A). The Court noted the plain language of the statute, which defined the term as a person “who provides any bankruptcy assistance to an assisted person.” In turn, bankruptcy assistance includes the “provi[sion of] legal representation with respect to a case or proceeding,” which clearly can only be provided by an attorney.¹³ The Court quickly dispatched with *Milavetz*’ remaining arguments, refusing to stray from what it perceived as the plain meaning of the definition.

The Related Provisions are Constitutional

The Court then analyzed the constitutionality of the § 526 limitations on advice and the § 528 mandated disclosures in advertising, as applied to attorneys, holding that neither violates the First Amendment. The Court rejected the Eighth Circuit’s broad reading of the § 526 limitation, refusing to find that it limits *all* advice related to *any* incurrence of debt – a reading that would include beneficial advice that might even avoid the necessity of a bankruptcy filing. Instead, the Court viewed the restriction narrowly, noting that the phrase “in contemplation of bankruptcy” presupposes a type of abuse aimed at “loading up” on debt immediately before the bankruptcy

¹² *In re Attys. At Law and Debt Relief Agencies*, 332 B.R. 66, 71 (Bankr. S.D. Ga. 2005).

¹³ 11 U.S.C. § 101(4A).

petition. The Court then remanded the case to the Eighth Circuit to consider whether, in this reworded form – preventing an attorney only from “advising a debtor to incur more debt because the debtor is filing for bankruptcy, rather than for a valid purpose” – the prohibition violates the First Amendment.¹⁴ Read in such a manner, it is difficult to see the Eighth Circuit invalidating the provision, as it only prevents advice leading to bankruptcy abuse and bankruptcy fraud and thus is likely to pass even the strictest scrutiny.

The Court then turned to the mandated advertising disclosures of § 528, holding that a less exacting standard of review applied because the restrictions (i) are aimed only at commercial speech and (ii) only mandate disclosure, and do not restrict any additional speech of the debt relief agency. As this standard requires only a reasonable relationship between the statute and the state interest in protecting consumers from commercial misleading speech, it is not surprising that the Court ultimately found the disclosures to be constitutional.

Practice Tip:

Following the *Milavetz* decision, it is clear that consumer bankruptcy attorneys need to be aware of, and are governed by, the requirements imposed upon debt relief agencies by the Bankruptcy Code. The Court’s opinion makes clear that the provisions of the Code will not be applied broadly to any advice given in anticipation of bankruptcy, but only advice seeking to abuse the process by encouraging a “loading up” of debt prior to filing. Specifically, the Court notes that “advice to refinance a mortgage or purchase a reliable car prior to filing [is not prevented] because doing so will reduce the debtor’s interest rates or improve his ability to pay is not prohibited . . . [nor is a]dvice to incur additional debt to buy groceries, pay medical bills, or make other purchases ‘reasonably necessary for the support or maintenance of the debtor or a dependent of the debtor.’”

Additionally, attorneys who regularly represent creditors in consumer bankruptcies can take comfort in the Court’s ruling that “bankruptcy assistance” to an “assisted person” only implicates advice or services provided to a consumer bankruptcy debtor – not to that debtor’s creditors. The definition of “assisted person” – “any person whose debts consist primarily of consumer debts” – does not specifically limit the definition to a person who has filed or is contemplating filing the bankruptcy that is the subject of the advice, leaving open the possibility that a creditor of a debtor that was itself a debtor could fall within the scope of this definition. This limitation affects not only the application of § 526’s limitation on advice, but also § 528’s mandated disclosure provisions. The Court directly addressed this concern, holding that these provisions “govern only professionals who offer bankruptcy-related services to consumer debtors.”¹⁵ As such, “advertisements aimed at creditors” – even creditors of a consumer debtor – need not comply with these provisions.¹⁶

Questions Remaining

The *Milavetz* opinion also raises several questions. The Court does not draw a bright line in defining prohibited advice under the statute. Several times throughout the opinion the Court refers to prohibited advice in such terms as “loading up,” “rather than for a valid purpose,” “impelling reason . . . was the prospect of filing for bankruptcy,” “manipulatively incurred,” and “abusive.” The Court suggests that it is not too high a burden to require attorneys to evaluate advice based on these standards, rejecting *Milavetz*’ argument that the restriction is vague and overbroad. Despite the Court’s approach, however, it is clear that its definition leaves significant gray areas, which are only partially eliminated by the examples provided by the Court regarding support and maintenance debts and refinancing mortgages. For example, it is unclear whether incurring debt for non-emergency medical procedures (which arguably do not qualify as necessary for support or maintenance) is covered by this provision. Additionally, is it proper to advise a debtor to borrow money to pay for required filing fees? For attorneys’ fees needed to prepare for bankruptcy? For expenditures aimed at affecting the

¹⁴ *Milavetz*, 559 U.S. ____ at *13.

¹⁵ *Id.* at *22.

¹⁶ *Id.*

means test calculus? For debts intended to utilize the various priorities and incentives provided by the Code? The Court assures attorneys that advice regarding “options that would be beneficial to both [debtors] and their creditors” is permitted, but what a debtor considers beneficial to all parties may often differ from what a creditor or the court considers beneficial.¹⁷

In light of these concerns, and the risk that advice falling outside the permitted guidelines could result in civil liability – including potential malpractice – it is easy to see how the *Milavetz* opinion will not entirely eliminate the chilling effect imposed by § 526. Consumer bankruptcy attorneys must therefore be careful to avoid the types of advice prohibited by § 526 and *Milavetz*, while simultaneously remaining mindful of their duties as zealous advocates of their clients. This may require a difficult balancing act, and it remains to be seen whether the Court is correct in suggesting that its definition is specific enough that “professionals cannot unknowingly run afoul of its proscription.”¹⁸

CONFLICTS OF INTEREST ISSUES

Dual Representation in Bankruptcy

Bankruptcy attorneys often represent more than one party in a case so long as those parties are not adverse to one another. However, disclosure of such dual representation is paramount. The following cases illustrate the importance of disclosure and the apparent consequences of nondisclosure.

In re Charles B. Marino, 09-33545-H3-11, 2009 Bankr. LEXIS 3149 (Bankr. S.D. Tex. Oct. 5, 2009)

Charles B. Marino filed an individual chapter 11 bankruptcy proceeding on May 22, 2009. Marino was the founder and former shareholder of Dinosaur Oil & Gas, Inc. (“Dinosaur”) and Italian-American Oil Co. (“Italian-American”). On May 28, 2009, Dinosaur and Italian-American, through the consent of their sole shareholder Mary Josephine Stone (“Stone”), also filed for chapter 11. These three cases were jointly administered.

Stone sought to employ attorney John H. Bennett, Jr. (“Bennett”) as debtor counsel for Dinosaur and Italian-American. In his application for employment and related declarations, Bennett disclosed that he also represented Stone, but was disinterested and held no interest adverse to the Debtors. Bennett further stated that the interests of Stone, Dinosaur, and Italian-American were aligned because they were all subject to claims asserted against Marino by some of his creditors.

The court noted that the “dual representation of a corporate debtor and its sole shareholder is not in and of itself an actual conflict of interest.” Rather, the “representation of entities with potentially conflicting interests does not violate section 327” of the Bankruptcy Code. “Whether an actual disqualifying conflict exists must be considered in light of the particular facts of each case.”

The court acknowledged that there was potential for conflicts to develop, but there was no actual disqualifying conflict at that time. Thus, the court approved the employment of Bennett, but noted that “[s]hould an adverse interest later become known or arise through other events, Bennett is required to disclose this information to the court.”¹⁹

In re Cypresswood Land Partners, I, 410 B.R. 247 (Bankr. S.D. Tex. 2009)

¹⁷ *Id.* at *15.

¹⁸ *Id.* at *18.

¹⁹ Presumably, if such an adverse interest would later arise, the court would likely reevaluate whether Bennett was still disinterested and perhaps utilize conflicts counsel or disqualify Bennett as a potential remedy.

Cypresswood Land Partners, I (“Cypresswood”), was a joint venture formed by Stephen A. Morrow (“Morrow”) and Redwood Properties, L.L.C. (“Redwood”) to buy, develop and sell certain real estate located along State Highway 290 in Houston, Texas (the “Property”). On November 28, 2006, Morrow engaged a law firm (the “Law Firm”) to represent him in connection with his Cypresswood investment.

On April 4, 2007, Morrow filed an involuntary chapter 11 petition against Cypresswood, and pursuant to an agreement with Redwood, took over as managing venturer of Cypresswood. The court entered an order for relief on June 25, 2007.

On July 17, 2007, the Court granted Cypresswood’s application to employ Law Firm as its counsel. The application disclosed that Law Firm previously represented Morrow in matters unrelated to the bankruptcy case and that Law Firm represented Morrow as the petitioning creditor who filed the involuntary petition.

While the Cypresswood bankruptcy case was pending, AT&T Advertising, L.P. sued Cypresswood, Redwood and Morrow for breach of contract. Morrow notified Law Firm of this suit, who responded they would “deal with this.”

Cypresswood’s Amended Plan was confirmed on January 21, 2009, under which Cypresswood would sell the Property to Grace Interests, L.L.C. (“Grace”), a limited liability company also managed by Morrow. Law Firm advised Morrow on December 28, 2008 that it could not represent Grace in this transaction; Morrow obtained separate counsel to represent Grace. However, Grace’s counsel was not given the Assignment and Assumption Agreement to review until the actual day of closing and Grace’s counsel never approved the same.

Law Firm filed its final fee application on April 22, 2009. Law Firm’s accounting records showed that after Cypresswood retained Law Firm as its counsel, it continued to receive payments from Morrow that were applied to Morrow’s personal account. On May 1, 2009, with the court’s permission, the Law Firm withdrew as counsel and another firm took over as debtor’s counsel. This new firm subsequently filed an objection to Law Firm’s final fee application alleging various inconsistencies and discrepancies.

At the hearing on the final fee application, Law Firm testified that Law Firm had ceased to represent Morrow individually. Morrow testified to the contrary, alleging that Law Firm continued to represent him throughout the chapter 11 case and continued to accept payment from him after Cypresswood filed for chapter 11 protection.

The court disqualified Law Firm and ordered disgorgement of all fees earned in the chapter 11 case. The court concluded that Law Firm never disengaged itself from representing Morrow individually. Further, Law Firm failed to comply with Texas Disciplinary Rule 1.02 because “[Law Firm] failed to expressly clarify its intent to terminate its individual representation of Morrow . . . [and] Morrow . . . reasonably supposed that [Law Firm] continued to represent him individually.” The court also held that Law Firm violated Texas Disciplinary Rule 1.15, which instructs attorneys how to properly decline or terminate representation. In fact, the court found that Law Firm had never disengaged itself from representing Morrow in his individual capacity.

Additionally, the court held that Law Firm failed to fully disclose its continued representation of Morrow. The court stated that “[d]isclosure is of utmost importance in bankruptcy cases Full and complete disclosure is required in bankruptcy cases. Violation of the disclosure requirement committed by an attorney may result in forfeiture of attorney’s fees.” By failing to disclose the facts surrounding Law Firm’s continued representation of Morrow individually and acceptance of payments from Morrow, Law Firm prevented the court from assessing its disinterestedness and therefore violated Bankruptcy Rule 2014 and 11 U.S.C. § 327.

Ultimately, Law Firm had to disgorge \$385,498.33 in fees and expenses.

Case Comparison:

While these two cases appear to conflict with one another, upon closer inspection, the holdings are in sync. As Judge Paul held in *In re Marino*, it is not necessarily an actual conflict if an attorney concurrently represents both the debtor and the debtor's founder/sole shareholder while the debtor's bankruptcy case is pending. However, Judge Bohm in *In re Cypresswood* disqualified debtor's attorney and disgorged its fees as a result of such dual representation. It is likely that it was not the actual dual representation of Morrow and Law Firm that caused Judge Bohm to disqualify Law Firm and disgorge its fees; rather, the lack of disclosure of such dual representation that prompted these differing results. By not disclosing the true nature of the representation, Law Firm prevented Judge Bohm from determining whether Law Firm was in fact disinterested under 11 U.S.C. § 327. As there does not appear from the facts to have been an actual conflict of interest between Morrow and Cypresswood, just potential ones, in all likelihood had such representation been disclosed Law Firm would have received similar treatment as Bennett: allowed to concurrently represent the debtor and founder/sole shareholder unless an adverse interest arose at which time the court would reevaluate the representation and disinterestedness of the attorney.

Practice Tip:

DISCLOSE, DISCLOSE, DISCLOSE! And when in doubt, disclose. Also, look for mid-case events that require disclosure.

Informed Consent

Given the nature of the practice and the number of parties that may be involved in any given bankruptcy case, bankruptcy attorneys are continuously faced with potential conflicts of interest. One method of dealing with such potential conflicts is to obtain waiver letters from applicable parties. The following case illustrates, however, that simply obtaining such a letter may not insulate a firm from liability.

Asset Funding Group, L.L.C. v. Adams & Reese, L.L.P., 07-2965, 2009 U.S. Dist. LEXIS 107819, (E.D. La. Nov. 4, 2009)

Asset Funding Group L.L.C. ("Asset") purchased three properties from Evans Industries, Inc. ("Evans") in April 2005, and subsequently leased back two of those properties to Evans. Evans later filed for chapter 11 bankruptcy in 2006. Adams & Reese, L.L.P. ("A&R") was retained as Asset's counsel to represent Asset during Evans' bankruptcy proceedings.

A&R had represented and was also concurrently representing Greif Industrial Packaging & Services, LLC ("Greif"), an entity who was interested in purchasing Evans' assets out of bankruptcy. A&R's concurrent representation of Greif presented a potential conflict of interest with its representation of Asset as Greif indicated in a letter dated September 6, 2006 that Greif would seek to reject the lease agreement with Asset if Greif won the bid for Evan's assets.

After learning of Greif's letter, A&R notified Asset of the potential conflict of interest. Asset's managing member signed a waiver-of-conflict letter consenting to A&R's continued representation on September 14, 2006. Greif successfully won the bid for Evans' assets on September 20, 2006. Greif entered into negotiations with Asset on the two leased back properties for new lease terms; A&R represented Asset in these lease negotiations.

Asset later filed suit against A&R asserting, among other things, that A&R failed to timely inform Asset of the conflict of interest involving Greif, failed to pursue certain insurance claims, gave bad advice related to the sale of Evans' assets, and failed to investigate and advise Asset on environmental issues related to the leased properties.

Asset further contended that when it gave its consent to A&R's concurrent representation of Asset and Greif in the September 14, 2006 letter, it did so with the limitation that a third party would represent Greif on the lease issues that give rise to the conflict. Asset also alleged that this type of conflict was nonconsentable as A&R continued to represent Greif on environmental due diligence, which affected Greif's decisions as to its lease negotiations with Asset. Asset's expert opined that the conflict waiver caused Asset damages because A&R did not assert certain lease rejection damages and environmental claims on behalf of Asset as a result of the concurrent representation.

A&R argued that Asset never had a claim against Greif in the Evans bankruptcy proceeding, thus, the representation did not involve a conflict whereby one client was asserting a claim against another client. Asset countered that it could have objected to Greif's bid as being procured through improper means, but such objection did not occur as A&R was concurrently representing both Asset and Greif.

Asset also claimed it did not give informed consent to A&R's concurrent representation of Greif as A&R merely walked Asset through the conflict letter, rather than discussing the nature of the potentially differing interests of A&R's clients and the risks of joint representation. A&R filed a motion for summary judgment on these issues.

The court held that "a waiver by a client of objection to a conflict is not a waiver of that client's right to complain about the intentional infliction of harm by the attorney or the obvious negligence of the attorney to prevent such harm." The court ultimately held that A&R's concurrent representation caused Asset harm and Asset did not give informed consent relative to its claims concerning the Greif interests. A&R's motion for summary judgment with respect to the Greif interests was denied.

Practice Tip:

Simply getting your client to sign a conflict waiver may not insulate you or your firm from potential conflicts liability stemming from dual representation. Make sure any waiver follows the informed consent guidelines enumerated in the applicable disciplinary rules. *See, e.g.*, Model Rule 1.7 and comments thereto. Under the new proposed Texas Disciplinary Rules, informed consent connotes "an agreement by a person to a proposed course of conduct after the lawyer has adequately explained the material risks of and reasonably available alternatives to the proposed course of conduct." Thus, you should take the steps necessary to obtain informed consent, and where possible, document such steps so you can demonstrate that any consent given was in fact informed.

PRIVILEGE ISSUES

Who Owns the Privilege?

When privilege is asserted, it is often an issue as to whether the person raising the privilege defense has a right to do so, especially if such party is a successor to the privilege (*e.g.*, a trustee who is administering the plan). The following case provides a good reminder of which parties hold a privilege.

***In re Hardwood P-G, Inc.*, 403 B.R. 445 (Bankr. W.D. Tex. 2009)**

The debtors filed chapter 11 petitions on January 9, 2006 and an Official Committee of Unsecured Creditors (the "Committee") was appointed on January 24, 2006. Law Firm ("Law Firm") was hired to represent the Committee. Alvarez & Marsal ("A&M") was retained as the Debtors' forensic accountants to investigate the Debtors' potential causes of action for preferential and fraudulent transfers.

A&M prepared a report (the “A&M Report”) for the Debtors detailing its specific findings as to the Debtors’ possible claims. The A&M Report was shared amongst the Debtors, the Committee and the secured lenders. Law Firm also prepared a report (the “Law Firm Report”) for the Committee concerning a number of matters, including the Debtors’ possible preference and fraudulent conveyance causes of action. The Law Firm Report was shared only with the Committee and its members. The Committee was later authorized, with the consent of the Debtors and the secured lenders, to bring certain estate claims on behalf of the Debtors for the recovery of preferences and fraudulent conveyances. The parties sued included Robert Earl Adams (“Adams”) and Signature Mouldings & Millworks, Inc. (“Signature”).

The Debtors’ Plan of Reorganization was confirmed on December 8, 2006, which provided for the formation of a litigation trust (the “Litigation Trust”) and assigned various causes of action, including preference and fraudulent conveyance actions that had already been commenced, to the Litigation Trust. In addition, all assets of the Debtors’ vested in the Litigation Trust.

The Litigation Trust trustee (the “Trustee”) gained access to the Law Firm Report and the A&M Report (collectively, the “Reports”) after the Litigation Trust succeeded to the Committee’s interests. Adams & Signature sought copies of the Reports during discovery related to the preference/fraudulent conveyance adversary proceeding commenced against them individually. The Trustee filed a motion for a protective order arguing the Trustee holds the attorney-client privilege with respect to the Law Firm Report as the report was prepared for Law Firm’s client, the Committee, and the Litigation Trust succeeded to all of the interests of the Committee. As for the A&M Report, the Trustee argued the report was prepared for the Debtors and when the Debtors’ assets vested in the Litigation Trust the attorney-client privilege vested in the Trustee. Alternatively, the Trustee claimed he could still assert attorney-client privilege with respect to the Reports because he had a common legal interest with the Committee and the lenders to pursue and liquidate the estate’s legal causes of action and to realize the value of those assets for the benefit of the creditors. Finally, the Trustee argued that the Reports were protected by the work product doctrine as they were prepared in anticipation of litigation.

Adams & Signature argued that the Law Firm Report was not privileged because (1) the attorney-client privilege could only be asserted by the Committee – the party for whom the report was prepared, (2) the Law Firm Report was not kept confidential because it was distributed to the various Committee members, the Trustee and the Trustee’s counsel, (3) the common interest doctrine is inapplicable because the parties are co-plaintiffs, not co-defendants, (4) the report was not work product because it was not prepared in anticipation of litigation as the issues addressed in the Law Firm Report were not related to the issues involved in the adversary proceeding, and (5) the report should be produced to prevent the defendants from having to comb through 300 boxes of information, which would constitute undue hardship.

Adams & Signature further argued the A&M Report was not privileged because (1) it was created by an accounting firm, not an attorney so it cannot be privileged, and (2) the report was not kept confidential as it was shared amongst the Debtors, the Committee, Law Firm, the secured lenders and other attorneys. The parties also argued that the A&M Report could not meet the common interest doctrine or the work product doctrine for the same reasons that applied to the Law Firm Report.

The court, citing *Commodity Futures Trading Commission v. Weintraub*,²⁰ held that the “right to assert or waive the attorney-client privilege of the debtor corporation rests with the trustee in a bankruptcy situation.” Further, the “transfer of *all* the assets of a corporation, such that nothing is left behind, may result in a transfer of the privilege that inheres in the attorney-client relationship.”²¹ Thus, the Trustee became the holder of the Debtors’ attorney-client privilege when the Debtors’ plan of reorganization went effective.

²⁰ 471 U.S. 343 (1985).

²¹ *Id.*

The court then went on to hold that the Reports were privileged. The court noted that normally disclosure to third parties waives any privilege; however, an exception applies for disclosures to accountants or other professionals hired to assist the attorney in providing advice to the client. The third-party professional's services must have enabled the giving of legal advice. In this case, with respect to the A&M Report, the court concluded it was clear the report was prepared to aid the communications between the Debtors and their counsel in evaluating potential causes of action, and thus the report was a privileged attorney-client communication. As the Law Firm Report was not disclosed to third parties, there was no issue as to whether the attorney-client privilege was waived by disclosure.²²

Furthermore, the court held the common interest doctrine can apply to plaintiffs as well as to defendants; there is no reason for any distinction otherwise. The court held the Trustee in this case had properly asserted the common interest doctrine as between the Debtors, the Committee and the secured lenders, further protecting it from waiver of the attorney-client privilege. A&M was hired for the purpose of analyzing the Debtors' potential causes of action and at the time the A&M Report was shared, all three entities were working toward the common goal of identifying and pursuing such causes of action.

When analyzing whether the Reports were protected attorney work product, the court noted that such a determination was a fact intensive one. The court ultimately concluded the Reports were prepared by Law Firm and A&M in anticipation of litigation and constituted both Law Firm's and A&M's mental impressions and strategies with regard to the pending adversary proceeding. Thus, the Reports were found to be opinion work product, and the Trustee succeeded to the Debtors' and Committee's right to assert work product privilege. The Reports did not cease to be opinion work product simply because a plan had been confirmed.

The court held that neither Adams nor Signature had demonstrated compelling circumstances to justify setting aside the opinion work product doctrine. Simply asserting that life would be easier with access to the reports was not enough to qualify for the undue hardship exception to the work product doctrine. The fact that Signature and Adams would be given access to the same documents the Trustee and his professionals reviewed, which would contain the same underlying factual information as that contained in the Reports, further weighed against finding undue hardship. Thus, the court concluded the Reports were further protected from disclosure as opinion work product.

Practice Tip:

Attorney-client privilege and attorney work product will continue to be applicable and will vest in a trustee after a plan has been confirmed, provided such plan provides for the vesting of such assets in the liquidating/litigation trust.

Definition of Work Product

A recent First Circuit case outside of the bankruptcy context has created considerable questions as to what constitutes attorney work product. Petition for certiorari for the *Textron* case is currently pending, and eleven *amici* briefs have already been filed. The case is important to note and follow for both bankruptcy and non-bankruptcy attorneys alike as what constitutes work product is clearly important to everyone.

***United States v. Textron, Inc. & Subsidiaries*, 577 F.3d 21 (1st Cir. 2009)**

Textron is one of the nation's largest corporations, and its tax returns are routinely audited. In the 2001 tax year, one of Textron's subsidiaries engaged in several transactions that were later identified as "listed

²² The court quickly dismissed the argument that the Law Firm Report was disclosed because it was shared with the Committee members recognizing that a statutory committee may hire counsel and any communications between such committee and counsel are privileged.

transactions,” for which the IRS would seek all of the taxpayers “tax accrual work papers” for the tax year in question, regardless of whether those work papers pertained to the listed transactions at issue. In response to an IRS summons, Textron agreed to provide certain documents but withheld others related to its return as a whole, including (1) a spreadsheet prepared by its in-house lawyers that listed items on its return whose treatment was uncertain, and as to each item estimated the likelihood of success in the event of a dispute; and (2) background memoranda that set out the legal analysis behind the estimates. The government filed a petition to enforce the summons. Before the district court, Textron argued that the withheld documents were protected by the work product privilege. Textron supported this contention with affidavits regarding the method by which the documents were prepared and presented testimony in an evidentiary hearing concerning the documents’ purpose. The head of Textron’s tax department testified that while one purpose of the documents was to assist Textron’s independent auditor in reviewing the amount set aside in reserve for potential tax liabilities in the event of disputes, another purpose was to guide Textron in making litigation or settlement decisions concerning the tax treatment of the specified items.

The district court held that the documents at issue were covered by the work product privilege, holding that “the relevant inquiry was whether the document was prepared or obtained ‘because of’ the prospect of litigation.” Under the “because of” standard, the district court determined that the documents would not have been prepared at all but for the fact that Textron anticipated the possibility of litigation with the IRS. If such litigation had not been anticipated, there would have been no reason to establish any reserves or to prepare the work papers used to calculate such reserves.

The government appealed. A divided panel of the First Circuit Court of Appeals initially affirmed that holding, but on *en banc* review, the Court of Appeals reversed by a three-to-two vote. Ultimately, the Court of Appeals held that the work-product privilege reached only documents that were “prepared *for use* in possible litigation.” The court explained that “it is not enough to trigger a work-product protection that the subject matter of the document relates to a subject that might conceivably be litigated. Nor is it enough that the materials were prepared by lawyers or represent legal thinking. The court added without elaboration that “every lawyer who tries cases knows the touch and feel of materials prepared for a current or possible lawsuit.” The court also stated that “any experienced litigator would describe the tax accrual work papers as tax documents and not as case preparation materials.” The court ultimately held that there is no evidence in this case that the work papers were prepared for use in litigation or would in fact serve any useful purpose for petitioners for Textron in conducting litigation if it arose.

Discussion:

The First Circuit’s Textron *en banc* opinion deepens a preexisting and long standing Circuit conflict. Nine courts of appeals have adopted a somewhat inconsistent but uniformly broader view of the work product scope, which is generally something along the lines of the “because of” standard. In applying this standard, courts of appeals have focused on whether the document at issue would not have been prepared but for the prospect of litigation, or whether the document was prepared for a litigation-related purpose, even if it was prepared for another purpose as well. This standard does not generally consider whether litigation was a primary or secondary motive behind the creation of the document, but rather it affords protection when the document would not have been created in substantially similar form but for the prospects of litigation.

The Fifth Circuit takes a narrower view in which the relevant inquiry is whether the “primary motivating purpose” for which the document was prepared was to assist in litigation. The Fifth Circuit has held that the work-product privilege would not cover work papers like those at issue in the Textron case on the grounds that, even though papers forecast the ultimate likelihood of sustaining the company’s position in court, because the primary motivating force behind their preparation was not to ready the company for litigation over its tax returns but rather to anticipate for financial reporting purposes what the impact of litigation might be on the company’s tax liability. The Fifth Circuit standard has been rejected by a number of the courts that have adopted the “because of” standard and it has been criticized by commentators as being too narrow.

The First Circuit, which once appeared to adhere to the “because of” standard, has now leapfrogged past the Fifth Circuit on the “narrowness continuum,” and advocates the far narrower “for use” standard. In applying the “for use” standard to the facts of the *Textron* case, the court concluded that “there is no evidence in this case that the work papers were prepared for use in litigation or would in fact serve any useful purpose for *Textron* in conducting litigation if it arose.” Oddly, the court credited the evidence below of the *non-litigation* use of the papers, while *ignoring* testimony that such papers were also used for analyzing risk and settlement strategies should such disputes arise.

Under the “because of” test, *Textron*’s documents would be privileged. It is clear that such documents would not have been prepared at all but for the prospect of litigation with the IRS.

Practice Tip:

Attorneys must be careful in preparing written risk assessments of existing or anticipated disputes given the potential discoverability of such documents, particularly within the First Circuit and perhaps the Fifth Circuit. Practitioners also should look for other ways to cloak risk assessments in privilege – for example, attorney-client privilege – to avoid solely relying on work product privilege.

This warning is particularly applicable in the bankruptcy context as *Textron* creates issues for attorneys and their dealings with financial advisors. For example, often in complex chapter 11 cases, bank groups hire their own financial advisors to assist their attorneys in protecting their interests in the case. *Textron* now calls into question the privileged nature of any assessments those financial advisors perhaps once enjoyed. Given that a debtor decides in what jurisdiction to file its bankruptcy petition, it is entirely possible that a bank group for a large debtor could end up within the bounds of the First Circuit without much say in the matter, and thus will need to evaluate its communications with its financial advisor in light of *Textron*.

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APPENDIX

C O N T E N T S	
	PAGE
1	
2	ORAL ARGUMENT OF
3	MADELEINE C. WANSLEE, ESQ.
4	On behalf of the Petitioner
5	TOBY J. HEYTENS, ESQ.
6	On behalf of the United States, as amicus
7	curiae, supporting the Petitioner
8	MICHAEL J. MEEHAN, ESQ.
9	On behalf of the Respondent
10	REBUTTAL ARGUMENT OF
11	MADELEINE C. WANSLEE, ESQ.
12	On behalf of the Petitioner
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1 but in this instance, the bankruptcy judge does have
2 that extra, Well, no, I read this as being something
3 that's too important for me to let the parties stipulate
4 away. That's the only reason that I don't go completely
5 with your hypothetical.

6 JUSTICE ALITO: Was the Ninth Circuit
7 correct in saying that an attorney can't be sanctioned
8 under the bankruptcy rules' equivalent version of Rule
9 11, for attempting to sneak through a discharge of
10 student debt in a Chapter 13 petition?

11 MR. MEEHAN: Justice Alito, number one, we
12 don't have a case here of sneaking through. I do want
13 to make that point. This was clear notice.

14 Number two, I think the bankruptcy court --
15 excuse me, the Ninth Circuit was not wrong, because in
16 the Ninth Circuit, there was binding precedent. The --

17 JUSTICE ALITO: I understand that. But in
18 the absence of circuit -- controlling circuit precedent,
19 is it -- can an attorney be sanctioned for attempting to
20 get the discharge of student debt through a Chapter 13
21 petition, knowing, as I assume every bankruptcy attorney
22 knows, that that is not the proper way to attempt to get
23 discharge of a student debt, student loan?

24 MR. MEEHAN: I'm not able to tell you as a
25 matter of subtle Ninth Circuit law that that is or is

1 not the case.

2 JUSTICE ALITO: I am not interested in what
3 Ninth Circuit law is.

4 MR. MEEHAN: Then, Justice Alito, I thought
5 you had been asking under Ninth Circuit law. You're
6 saying as a matter of --

7 JUSTICE ALITO: No, I'm asking you -- I'm
8 asking you, under bankruptcy Rule 9011.

9 MR. MEEHAN: My position would be that if it
10 is up front, clear notice, in effect, a proposal that we
11 just don't have a Federal case out of an undue hardship
12 determination for \$4,000, that it does not violate
13 Rule 11 or 9011 to make that proposal.

14 If there is some sort of lack of candor or
15 if there's some sort of weaseling, one might say,
16 perhaps. And I think it's interesting that those
17 courts, which have said that this is not something that
18 bankruptcy lawyers should do, have not, so far as I was
19 able to find, invoked Rule 11 or Rule 9011.

20 JUSTICE GINSBURG: But did you -- the net
21 effect of this is you have taken a debt that is
22 non-dischargeable and put it into the category that it
23 is dischargeable unless the creditor objects.

24 MR. MEEHAN: Yes.

25 JUSTICE GINSBURG: The -- the code puts the

1 onus on the debtor to raise the hardship question.

2 Your reading is, even if the debtor is
3 silent, totally silent, says nothing about hardship,
4 unless the creditor objects, then the discharge will be
5 proper; the plan can be confirmed. So you are taking a
6 burden that Congress has put on the debtor and switching
7 it to the creditor?

8 MR. MEEHAN: Well, Justice Ginsburg, I would
9 say that it doesn't shift the burden. It -- it does
10 shift the going forward, I suppose, in the sense of
11 making it an objection.

12 But let's remember that this is something
13 that would obviously have been reversed on appeal had
14 the --

15 JUSTICE BREYER: But why would it not be a
16 sanctionable matter under Rule 11? If -- the lawyer
17 knows that he is supposed to make this special claim to
18 get this kind of discharge. He knows an ordinary claim
19 won't do it. He submits a paper that asks for the
20 ordinary discharge, that he has to sign it, and that
21 sign, that signature, is a -- is a certification that to
22 the best of his knowledge, the claims and other legal
23 contentions are warranted by existing law.

24 So if he signs it, knowing that that isn't
25 the way to do it -- indeed, there is not even an

1 argument for doing it that way, for modifying the law --
2 then why isn't that a sanctionable matter under Rule 11?

3 MR. MEEHAN: I am not here to say absolutely
4 it is not, Justice Breyer.

5 What I'm saying, I think, is that some of
6 the bankruptcy courts in some of the circuits have said,
7 at least without invoking Rule 11, that it is improper.
8 Others have not had that difficulty. I, as a lawyer who
9 has litigated for 39 years and is very conscious of
10 Rule 11, have never thought that if -- again, if it was
11 something that was plain and not obfuscated, that a
12 proposal to simply omit one element of a claim violated
13 Rule 11. I think it's debatable --

14 JUSTICE BREYER: The reason I ask that is, I
15 think the argument on the other side is that it's so
16 clear in the law that this is not the way to go about it
17 that you have to make a separate piece of paper saying
18 you have special hardship; that that is so clear what
19 Congress wanted that four years later you can come back
20 and attack it, if they didn't do it. I mean, that's
21 basically, in my mind, their argument.

22 But I think a simpler way would be to say if
23 it's that clear, if it really is that clear, the bar
24 itself will enforce the rule by not knowingly deviating
25 from the way that Congress set it out, to which there is

1 no legal objection. Now, is it really -- what do you
2 think of that?

3 MR. MEEHAN: I think that -- I think that,
4 again, in the context of what this case -- the issue of
5 this case, I think that's right.

6 I think -- and this Court said in Taylor v.
7 Freeland & Kronz that we are not going to adopt a rule
8 respecting finality that is going to take all the onus
9 of policing the bar, and noted that rule in criminal
10 bankruptcy fraud and the requirement that a petition be
11 signed and filed on a verification. And I think that's
12 -- I think that's absolutely right. I think that --

13 JUSTICE SCALIA: If that is the price of
14 your winning this case, it's clearly worth it now. I am
15 agreeing with Justice Breyer on that point.

16 MR. MEEHAN: You mean that the bar may have
17 further scrutiny?

18 JUSTICE SCALIA: Yes. I mean, if indeed the
19 Court would not be willing to go along with -- with your
20 assertion that you can't undo it later, once it's been
21 done, unless it is clear that it should not be done and
22 that the bankruptcy judge shouldn't do it, and that the
23 lawyer shouldn't propose it -- if that's the condition,
24 then you should accept it, right? Because you want to
25 win this case.

1 MR. MEEHAN: I would accept -- I would
2 accept that in any condition. I would accept that
3 condition on direct review or on Rule 60. Or even --

4 JUSTICE KENNEDY: I was going to ask whether
5 or not in -- on the facts of this case the client could
6 have voided into the final judgment, not appeal, but
7 then come in under Rule 60?

8 MR. MEEHAN: I think that they could have.
9 Rule 60, as it --

10 JUSTICE KENNEDY: So then the client is not
11 required to -- the creditor is not required to appeal?

12 MR. MEEHAN: Well, they take the risk,
13 Justice Kennedy, that they could fit within 60, A, B, or
14 C: Surprise, inadvertence, mistake, inexcusable
15 neglect, fraud, et cetera.

16 In this instance, I think they might have
17 had a hard time, because at most stage --

18 JUSTICE KENNEDY: All right. So I don't
19 think they could have -- and of course, you don't think
20 it's void. It could come in under 60(b) if it's void,
21 but you don't think it's void.

22 MR. MEEHAN: Well, void, under those
23 circumstances, I think would throw us into the due
24 process issue and I don't think so. No, I do not think
25 so.