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In Bankruptcy, Attorney-Client Privilege **Is Not Absolute**

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The U.S. Bankruptcy Code gives debtors access to powerful rights and remedies that are not available under non-bankruptcy law. As a balance to these extraordinary powers however, a debtor may lose some or all control over its own affairs under certain circumstances. One of the rights that the debtor "puts into play" when it files bankruptcy is the attorney-client privilege (the Privilege). This article addresses two ways in which a debtor can lose the right to assert the Privilege, and similarly how creditors, trustees, and interested parties can succeed in obtaining privileged communications during the bankruptcy proceeding.

Trustees' Control Of Attorney-Client Privilege

In *Commodity Futures Trading Comm'n v. Weintraub*[1] the U.S. Supreme Court held that the "trustee of a corporation in bankruptcy has the power to waive the corporation's attorney-client privilege with respect to pre-bankruptcy communications."[2] In *Weintraub*, the debtor was a discount commodity brokerage house registered with the Commodity Futures Trading Commission (CFTC). Before the filing of the bankruptcy petition, the debtor was under investigation by the CFTC. Shortly after the debtor filed a petition under Chapter 7 of the Bankruptcy Code, the CFTC subpoenaed the debtor's former counsel seeking testimony regarding various matters, including suspected fraudulent activities. The former counsel refused to answer certain questions, asserting the debtor's attorney-client privilege. At the request of the CFTC, the Chapter 7 trustee waived the attorney-client privilege on behalf of the debtor. The CFTC then succeeded in compelling the former attorney to comply with the subpoena. In support of its holding, the Supreme Court concluded that "vesting in the trustee control of the corporation's attorney client-privilege most closely comports with the allocation of the waiver power to management outside of bankruptcy without in any way obstructing the careful design of the Bankruptcy Code."[3]

The Supreme Court in *Weintraub* was clear that their holding "ha[d] no bearing on the problem of individual bankruptcy." The lack of guidance from the Supreme

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Court and Circuit Courts has produced much conflicting case law on the issue. Generally, courts fall within three groups when deciding who controls the Privilege during a bankruptcy proceeding: those that: (1) permit the trustee to control the Privilege; (2) permit the debtor to control the Privilege; and (3) utilize a balancing test based upon the facts and circumstances of the case to determine who controls the Privilege.[4] A recent bankruptcy court commented that the trend of the cases is toward a balancing approach.[5] The authors have not found a single reported decision in the Second Circuit to address who controls the Privilege in an individual's bankruptcy.

Not only is there a concern that the Privilege is waived by a bankruptcy trustee, the **crime-fraud exception may expose attorney-client communications** made in furtherance of an alleged fraudulent transfer that occurred prior to the bankruptcy.

A business (or individual) filing under Chapter 11 of the Bankruptcy Code still risks losing control of the Privilege. Unlike in a Chapter 7 case where a trustee is appointed by operation of law, a Chapter 11 debtor enjoys the rights and responsibilities of a trustee (a "debtor-in-possession" in bankruptcy parlance) and can continue operating its business. However, under §1104 of the Code, a trustee can be appointed by motion (which is very unusual). In addition, under §1104 a case that is filed as a Chapter 11 can later be converted to a Chapter 7 case if, among other things, the debtor fails to reorganize (which is much less unusual). Lastly, courts have allowed examiners,[6] similar to a trustee but whose role is much more limited, to assume control of a debtor-in-possession's Privilege, as was the case in the *Enron* bankruptcy.

Fraudulent Transfers And Crime-Fraud Exception

Not only is there a concern that the Privilege is waived by a bankruptcy trustee, the crime-fraud exception (the Exception) may expose attorney-client communications made in furtherance of an alleged fraudulent transfer that occurred prior to the bankruptcy. Although fraudulent transfer claims exist under both state law and bankruptcy law, fraudulent transfer litigation more commonly arises in bankruptcy.

In the Second Circuit, application of the Exception applies where there is: (1) a determination that the client communication or attorney work product in question was itself in furtherance of the crime or fraud; and (2) probable cause to believe that the particular communication with counsel or attorney work product was intended in some way to facilitate or to conceal the criminal or fraudulent activity.[7] The fact that the communication itself might provide evidence of a fraud or crime is not enough to vitiate the Privilege. Moreover, the Exception applies even if the attorney was not aware that the advice was sought in furtherance of an improper purpose.

Attorneys do not usually perceive an intentional fraudulent transfer made with "actual intent to hinder, delay, *or* defraud"[8] a creditor as "real" fraud (e.g., common law fraud or securities fraud). Certainly, all bankruptcy and commercial attorneys (hopefully within the bounds of the law and ethics) have at some point advised insolvent clients on how to avoid paying debts. Nonetheless, the U.S. Court of Appeals for the Second Circuit has applied the Exception to communications made in furtherance of an alleged fraudulent conveyance under New York Creditor Debtor Law §276.[9] So have bankruptcy courts, including the Bankruptcy Court for the Southern District of New York.[10] A recent decision by Judge Eileen Bransten of the New York Supreme Court, County of New York, demonstrates how the probable cause standard for applying the Exception is not as rigorous as it may sound.[11]

Conclusion

Businesses and individuals in financial distress have a propensity to do things, and say things to their attorneys, that can expose them to liability. The Privilege ingrains in attorneys a sense of invincibility when it comes to shielding communications with their clients. However, attorneys must be mindful when communicating with financially distressed clients that, under certain circumstances, the Privilege is not absolute.

1. 471 U.S. 343 (1985).
2. 471 U.S. at 358.
3. 471 U.S. at 354.
4. *In re Still*, 444 B.R. 520, 522-23 (Bankr. E.D. Pa. 2010).
5. Id.
6. See 11 U.S.C. §§1104, 1106.
7. *In re Richard Roe*, 168 F.3d 69, 71 (2d Cir. 1999).
8. 11 U.S.C. 548(a)(1)(A); N.Y. Debt. Cred. Law §276.
9. *In re Grand Jury Subpoena Duces Tecum Dated Sept. 15, 1983*, 731 F.2d 1032, 1034 (2d Cir. 1984).
10. *In re MarketXT Holdings*, 2009 WL 7216076, at *3 (Bankr. S.D.N.Y. March 4, 2009) (Bernstein, J.). See also *In re Certified HR Servs. Co.*, 2008 WL 2783157, at *1 (Bankr. S.D. Fla. July 16, 2008); *In re Andrews*, 186 B.R. 219, 222 (Bankr. E.D. Va. 1995).
11. *Fragin v. First Funds Holdings*, 2016 WL 4256984 (N.Y. Sup.), 1, 2016 N.Y. Slip Op. 31537(U), 3 (N.Y. County Sup. Ct.).