The Ethics Trifecta: How to Avoid Sanctionable Lawyer Behavior, Crossing the Line in Pre-Petition Planning, and Dangerous Conflicts of Interest

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Sanctionable Behavior: What is it and how to avoid it.

Peter G. Cary, Chief Judge
United States Bankruptcy Court
for the District of Maine

Bankruptcy Court's Sanction Power – Generally.[1]

I. F. R. Bankr. P. 9011.

(b) Representations to the Court. By presenting to the court (whether by signing, filing, submitting, or later advocating) a petition, pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, —

(1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;

(2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;

(3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and

(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

II. Inherent Authority.

11 U.S.C. §105(a): *"The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."*

III. 28 U.S.C. §1927. *"Any attorney or other person admitted to conduct cases in any court of the United States or any Territory thereof who so multiplies the proceedings in any case unreasonably and vexatiously may be required by the court to satisfy personally the excess costs, expenses, and attorneys' fees reasonably incurred because of such conduct."*

[1] The Code also grants specific authority to issue sanctions in a variety of sections for improperly filing involuntary petitions, violating the automatic stay, alleging fraud without substantial justification, filing coercive or otherwise improper motions to dismiss for "abuse", violating debt relief agency provisions, for example.

IV. Recent cases.

A. **Federal Rule of Bankruptcy Procedure 9011.**

In re Hoover, 61 Bankr. Ct. Dec. 125, 2015 WL 5074480 (D. Mass. 2015).[2]

Issue: Can the bankruptcy court sanction an attorney under Rule 9011 for misstating the law?

Answer: Yes.

Facts:

- The bankruptcy judge sanctioned debtor's counsel for two misrepresentations of legal authorities.
  - He determined that debtor's counsel misstated the legal standard for when a creditor willfully violates the automatic stay.
  - He concluded that the debtor's counsel selectively misquoted the statutory definition of "cash collateral".
- The misrepresentations "crossed the line separating good faith legal argument from the flagrantly improper."
- Sanction: counsel ordered to "enroll in and attend in person (not online) a one semester, minimum three credit hour class on legal ethics or professional responsibility at an ABA accredited law school." No money sanction: attorney previously sanctioned monetarily for similar actions.
- The debtor and debtor's counsel appealed.

Opinion:

- The district court noted the "broad discretion afforded to the bankruptcy court in fashioning rule 9011 sanctions".
- As to the first misrepresentation, counsel admitted that his pleading did not state the existing law regarding willful violations of an automatic stay BUT he argued that he was asserting a nonfrivolous request to extend or modify it as permitted under 9011(b)(2).
- The district court disagreed and concluded that the plain language of his pleading purported to represent the current state of the law, not a request to change it, and as such sanctions were appropriate.

[2] The District Court decision was appealed to the First Circuit and oral argument was held on May 2, 2016. United States Court of Appeals for the First Circuit Docket No. 15-2384.

- As to the second misrepresentation, counsel asserted that the statutory definition of "cash collateral" only encompassed cash or other property subject to a consensual lien and thus his client could use, without court permission or the creditor's consent, property which the creditor had encumbered with a statutory lien.

- Counsel argued that his paraphrasing of the statutory definition of "cash collateral" merely omitted needless words: "[C]ash collateral" means cash . . . subject to a security interest as provided in section 552(b)....

- Not so, according to District Court – the definition of cash collateral in the Code is much broader and the words that counsel excised hid the true meaning of "cash collateral".

> "[C]ash collateral" means cash*, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties* subject to a security interest as provided in section 552(b).... 11 U.S.C. § 363(a).

- If the attorney "had fully quoted the statutory definition of 'cash collateral', the flaw in his argument would have been obvious".

- No abuse of discretion.

B. **Inherent Power.**

In re Charbono, 790 F.3d 80 (1st Cir. 2015).

Issue: Does the bankruptcy court possess the inherent power to sanction parties for noncompliance with court orders?

Answer: **Yes** and such power is not subsumed within the bankruptcy court's authority to punish for criminal contempt.

Facts:

- Chapter 13 confirmation order required the debtor to deliver certain tax documents to the trustee.

- Debtor failed to do so.

- Trustee filed motion seeking dismissal plus $200 sanction.
- Debtor belatedly supplied the tax return.
- Trustee did not press for dismissal but wanted the sanction.
- Bankruptcy court agreed and issued a $100 sanction.
- Debtor appealed.

Opinion:

- Contempt power is only one of the many inherent powers that courts possess to protect the order and dignity of the courtroom and the judicial process.
- Using this authority, courts can levy sanctions (including punitive sanctions) for a variety of purposes including disciplining attorneys, remedying fraud, and preventing disruption.
- Courts can impose inherent powers sanctions without a finding of contempt.
- Sanctions pursuant to a court's non-contempt inherent power differ from contempt sanctions which require the court to make an express finding of contempt or some type of criminal intent.
- Here, the bankruptcy court's $100 award was not a criminal punishment but was an inherent power sanction for which no finding of contempt was necessary.
- Remaining question: do bankruptcy courts, like other federal courts, have the authority to impose punitive non-contempt sanctions.
    - Debtor argued that they do not; they are creatures of statute and lack such powers.
    - First Circuit disagreed.
        - See, Law v. Siegel, __ U.S. __;134 S.Ct. 1188, 1198 (2014).
        - Marrama v. Citizens Bank of Mass., 549 U.S. 365, 375-76 (2007).
        - Chambers v. NASCO, Inc., 501 U.S. 32, 43 – 44 (1991).
- "[A]ll courts are "necessarily vested" with the inherent power required to carry out their judicial functions to "achieve the orderly and expeditious

disposition of cases." In re Charbono, 790 F.3d 80, 86 (1st Cir. 2015) (citations omitted).

- The bankruptcy court was not required to establish "bad faith" for this sanction, as would have been the case in the award of attorney's fees, because the award of attorney's fees is a deviation from the "American Rule" and such a sanction requires heightened justification.

- No free reign though: courts must use inherent powers to sanction cautiously.

- Use of inherent power to sanction must address due process concerns - notice and opportunity to be heard.

- Observations about words. [3]

C. 28 U.S.C. §1927.

MJS Las Croabas Properties, Inc., 545 B.R. 401 (B.A.P. 1st Cir. 2016). No discussion as case is on further appeal filed by Appellant Castellanos Group Law Firm on February 24, 2016. United States Court of Appeals for the First Circuit Docket No. 15-36.

[3] This opinion contains some interesting words. Pellucid: "very clear." http://www.merriam-webster.com/dictionary/pellucid. (Popularity rating according to Merriam-Webster: 50%); Armanentarium: "a collection of resources available or utilized for an undertaking or field of activity; especially: the equipment, methods, and pharmaceuticals used in medicine." http://www.merriam-webster.com/dictionary/armamentarium. (Popularity rating: 40%); Ukase: "a proclamation by a Russian emperor or government having the force of law; edict." http://www.merriam-webster.com/dictionary/Ukase. (Popularity rating: 30%); Exigible: "liable to be exacted: requirable, demandable." http://www.merriam-webster.com/dictionary/exigible. (Popularity rating: 20% and Merriam further remarked: "Aren't you smart – you've found a word that is only available in the Merriam-Webster Unabridged Dictionary. To view the full definition of exigible, activate your free trial today."); Encincture: "to encircle with or as if with a girdle: gird <a lake encinctured with a belt of forest>.) http://www.merriam-webster.com/dictionary/encincture. (Popularity rating: 10%); and Woof: "weft; woven fabric; a basic or essential element or material." http://www.merriam-webster.com/dictionary/woof. (Popularity rating: 40%).

Pigs Smell, Hogs Stink
[Ethical Issues in Pre-Bankruptcy Planning]

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INTRODUCTION

"Pre-bankruptcy Planning" is generally viewed as the reorganizing of a debtor's property prior to filing a Bankruptcy Petition in order for the debtor to retain more assets than otherwise through the bankruptcy process. *Legitimate* pre-bankruptcy planning typically involves the permissible conversion of non-exempt assets into exempt assets. *Illegitimate* pre-bankruptcy planning includes, *inter alia*, fraudulent transfers of property, impermissible conversion of non-exempt assets into exempt assets, and rolling the dice on taking improper exemptions in the hope that no objection will be filed within the strict 30 day period provided by Rule 4003.

I. LEGISLATIVE HISTORY

In order to give the debtor a "fresh start," the Bankruptcy Code allows Debtors to *exempt* from distribution to creditors certain property of the Debtor. A review of the case law indicates that most Courts hold that legitimate pre-bankruptcy planning is presumptively permitted by the Code. This presumption from the oft-quoted piece of "legislative history" of the Bankruptcy Reform Act of 1978:

> As under current law, the debtor will be permitted to convert non-exempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 361 (1977); S. Rep. No. 989, 95th Cong., 1st Sess. 76 (1977).

Accordingly, when a debtor converts non-exempt assets to exempt assets with the intent to place them beyond the reach of creditors, such intent is not fraudulent in itself -- because it is consistent with the very purpose of exemptions. In re Smiley, 864 F.2d 562 (7th Cir. 1989). Absent actual intent to "hinder, delay or defraud a creditor," such conversions simply represent the debtor's "use of the exemptions to which he is entitled under the law." In re Carey, 938 F.2d 1073 (10th Cir. 1991); In re Corbett, 478 B.R. 62 (Bankr. D. Mass., 2012).

However, not all courts agree with this view of the legislative history. Judge Queenan, in In re Kravitz, 225 B.R. 515 (Bankr. D. Mass., 1998), explained that:

> The hearings referred to in the House report consist primarily of a letter written to Representative Edwards by Judge Aaron K. Phelps, a California bankruptcy judge. In the letter Judge Phelps states that "most of what is done in the name of 'pre-bankruptcy planning' borders on outright fraud, as far as I am concerned." He observes that in the Ninth Circuit "conversion of non-exempt assets into exempt assets on the eve of bankruptcy is not, standing alone, fraudulent" and that "the law on this point is in a state of utter confusion in other circuits. . . ."

Id. (internal citations omitted). See also, In re Spoor-Weston, 139 B.R. 1009 (Bankr. N.C. Okla. 1992); In re Schwarb, 150 B.R. 470 (Bankr. M.D. Fla. 1992).

As a practical matter, although courts generally accept the "congressional intent" to allow Debtors to perform legitimate pre-bankruptcy conversions of non-exempt assets to exempt assets, not all such pre-bankruptcy transactions are held to be acceptable.[1]

II. SOME GENERAL ETHICAL PRINCIPLES IN PRE-BANKRUPTCY PLANNING

Although the major focus of this work is on assessing whether facially legitimate pre-bankruptcy transactions are permissible, there are certain general principles regarding unethical attorney representation of clients in the pre-bankruptcy planning stage that ought to be self-evident (see, Milavetz, Gallop & Milavetz, P.A. v. U.S., 559 U.S. 229 (2010)), but bear brief review here:

A) Attorneys Must Accurately Advise Debtors Regarding Permissible Exemptions. See, e.g., In re Armwood, 175 B.R. 779 (Bankr. N.D. Ga. 1994); In re Smith, 143 B.R. 912 (Bankr. D. Neb. 1992).

B) Attorneys Must Not Advocate Illegal Transfers of Property, and Should Advise Clients to Reverse Illegal/Fraudulent Transfers of Property When Appropriate. See, e.g., In re Granite Sheet Metal Works, Inc., 159 B.R. 840 (Bankr. S.D. Ill. 1993); In re Rice, 109 B.R. 405 (Bankr. E.D. Cal. 1989); First Beverly Bank v. Adeeb (In re Adeeb), 787 F.2d 1339, 1345 (9th Cir. 1986) (fraudulent transfers can and must be reversed, thereby avoiding not only exemption litigation, but also objections to discharge under section 727(a)(2)); In re Hill, 562 F.3d 29 (1st Cir. 2009)(Important to ensure reversals are made prior to filing the petition because, under section 522(g), if the trustee "recovers" the property, the debtor loses the ability to subsequently claim exemption in the recovered property); Lassman v. Pratts (In re Pratts), 470 B.R. 234 (Bankr. D. Mass. 2012) (same).

C) Attorneys Must Not Advise Clients to Roll the Dice with the Strict Rule 4003(b) Objection Deadline. Unless an objection is timely made pursuant to Rule 4003(b), property the debtor claims as exempt will be exempted from the estate, even if there is no basis for the exemption under state or federal law. Taylor v. Freeland & Kronz, 503 U.S. 638 (1992). Hence, Debtors, and perhaps some counsel, may be tempted to claim property as exempt outside permissible limits, taking a chance that creditors or the trustee will not object within the strict 30-day time period. However, such schemes can easily backfire, leading to the denial of discharge, criminal fraud penalties, and/or Rule 9011 sanctions. Taylor, supra. See also, In re Smith, 143 B.R. 912 (Bankr. D. Neb. 1992).

III. PRE-BANKRUPTCY EXEMPTION PLANNING

A) General Right to Plan, Not to Defraud… There is no Safe Harbor.

Converting non-exempt assets into exempt assets is a practice that is not in and of itself illegal or improper, but neither is it proper *per se*, or insulated from scrutiny. There is no "safe harbor" for

[1] In addition to developed case law, several states have statutes aimed at restricting pre-bankruptcy planning, including: Texas, Wyoming, Ohio, Kansas, New Jersey, New York, Maine, and Illinois.

bankruptcy exemption planning. In Re Bronk, 444 B.R. 902 (Bankr. W.D. Wis. 2011); Gugino v. Orlando (In re Ganier), 403 B.R. 79 (Bankr. D. Idaho 2009).

The line between legitimate planning and impermissible transfers is not at all clear. Take, for example, these not-so-hypothetical hypotheticals:

- Debtor obtained an exempt insurance policy immediately prior to his bankruptcy using all his non-exempt assets to make a single premium payment of $7,500.00;[1]

- Use of $12,000.00 from sale of a motorcycle for the purchase of various exempt items (retirement fund, bankruptcy attorney, foundation donation, eye exam, groceries, and a life insurance policy);[2]

- Purchase of exempt annuity of $14,000.00, five days prior to bankruptcy and shortly after sued in state court, from sales proceeds of non-exempt stock;[3]

- Shortly before filing for bankruptcy and after consulting with counsel, Debtor used non-exempt funds to fund a $4,000 exempt Roth IRA for himself, a $4,000 exempt Roth IRA for his Wife, made a voluntary principal payment of $11,500 on his mortgage (in order to reach the maximum amount of exemption), and establish college tuition Section 529 accounts for his two children totaling $22,000.[4]

- Debtor engaged in transactions to dispose of or encumber his non-exempt assets totaling $20,000, via pre-paying $5,000 in alimony or property settlement to his ex-wife, paying off the loan on his truck; and borrowing monies from his ex-wife based upon funds given to her by her son (via a loan taken by the son on insurance policies given to him by the Debtor), and borrowing money from his daughter and granting a security interest to her on furniture, fixtures, commissions, boat, motor and trailer;[5]

- Debtors had car, two vans and motor home appraised and sold to their son at appraised value, and household furnishings to Husband's brother. Debtors used the $35,000.00 proceeds to purchase exempt life insurance policies and to prepay their homestead real estate mortgage;[6]

- The use of $40,000.00 sale of non-exempt Krispy Kream stock to pay down second mortgage against home, Debtors filed for bankruptcy 3 weeks later;[7]

- The conversion of a $42,000.00 non-exempt CD into an exempt annuity with a life insurance company shortly before filing for bankruptcy;[8]

- Debtor paid son's school tuition and purchased exempt annuities from $45,000 loan via Debtor's of his stock in his professional corporation;[9]

- Debtor's conversion of approximately $65,000.00 in non-exempt proceeds of sale into an exempt annuity approximately three months before deciding to file for bankruptcy, and a little over six months before filing their Petition;[10]

- Debtor converted nonexempt assets such as jewelry, a one-half interest in a corporation's assets, and her interest in a timeshare condominium into cash, then combined the cash proceeds with cash from other nonexempt sources such as tax refunds, the proceeds from the sale of cars, and a portion of her prepetition earnings, and used the funds to pay down the

mortgage on her exempt homestead, allowing the Debtor to emerge from bankruptcy with approximately $300,000 in equity in her home and a mink coat;[11]

- Debtor liquidated almost all of his nonexempt property, converting it into exempt life insurance and annuity contracts worth approximately $700,000.00;[12]

- Debtor rolled 1.4 Million Dollars from a non-exempt IRA into an exempt pension fund on the eve of bankruptcy; an arbitration award of 4.5 Million had previously entered against the Debtor.[13]

B) The "Tests" for Legitimacy are Vague and Ambiguous, and Courts Often Resort to Catch-Phrases to Define Illegitimate Pre-Bankruptcy Exemption Planning

Although pre-bankruptcy conversion of non-exempt assets to exempt assets is generally permitted, there are acts which Courts view as going too far. Albuquerque National Bank v. Zouhar (In re Zouhar), 10 B.R. 154, 157 (Bankr. D.N.M. 1981). As has been frequently quoted, "There is a principle of too much; phrased colloquially, when a pig becomes a hog it is slaughtered." Id.; see also, In re Krantz, 97 B.R. 514, 525 (Bankr. N.D. Iowa 1989) ("While there will be times when this Court cannot tell the difference between a pig and a hog, this is not one of those times."). The concept that there can be "too much" pre-bankruptcy exemption planning is contrary to the view that "ultimately, fixed dollar limits on the use of exemptions must be set by legislatures," not the Courts. In re Johnson, 880 F.2d 78, 83 (8th Cir.1989)).[2] Nevertheless, many courts appear to have subjective limits to how much exemption conversion they will tolerate, leading to ill-defined catch-phrases to identify impermissible pre-bankruptcy exemption conversions, i.e.:

- The "Smell Test." In re Johnson, 80 B.R. 953 (Bankr.D.Minn.1987); In re Carey, 96 B.R. 336 (Bankr. W.D. Okla. 1989), judgment aff'd, 112 B.R. 401 (W.D. Okla. 1989), aff'd, 938 F.2d 1073 (10th Cir. 1991);

- Is the Debtor being a pig or a hog? ("When a pig becomes a hog it is slaughtered"). Matter of Swift, 3 F.3d 929 (5th Cir. 1993);

- Is the Debtor getting a fresh start, or a head start? Norwest Bank Nebraska, NA v. Tveten, 848 F.2d 871 (8th Cir. 1988); Albuquerque National Bank v. Zouhar (In re Zouhar), 10 B.R. 154 (Bankr. D.N.M. 1981); and

- The principle of "too much."… In re Beverly, 374 B.R. 221 (B.A.P. 9th Cir., 2007); In re Thomas, 477 B.R. 778 (Bankr. Idaho, 2012).

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2 Other than the 2005 BAPCPA amendments regarding homestead exemptions, the Code does not provide that value or size of the transaction is a factor for analysis. See, In re Smiley, 864 F.2d 562 (7th Cir. 1989) (court rejected inclusion of "an unusually large amount of property ... claimed as exempt" among the factors to consider).

The problem with these "tests" is that there is no real guidance of when the Debtor has gone too far, smells too foul, became a hog, is getting a head start or fresh start, or has otherwise crossed the line from legitimate pre-bankruptcy exemption planning to the illegitimate.

C) Debtor's Intent to Hinder, Delay or Defraud Creditors, and the "Badges of Fraud" Inquiry… a Facially Objective Test That Produces Moving Targets

Perhaps recognizing that "smell tests," the principle of "too much," and deciding whether a debtor qualified as a pig or a hog are methodologies too vague standing alone, a leading line of cases have held that in order to find a pre-bankruptcy exemption conversion to be illegitimate, the Court must find on the evidence that the Debtor's actual intent in the transaction was to "hinder, delay or defraud creditors." However, as the Court poignantly pointed out in In re Lee, 309 B.R. 468 (Bankr. W.D. Tex. 2004):

> Any time a debtor converts nonexempt property into exempt property, the activity will have the inevitable effect of hindering and delaying at least some creditors. A rule of law that excused an objecting party from showing intent to defraud independent of the intent to hinder or delay (that is, after all, the point of acquiring an exempt asset with nonexempt property) would mean that any exemption acquisition with nonexempt property within one year of filing would, as a matter of law, automatically disqualify the debtor from receiving a discharge.

Hence, most Courts require *extrinsic* evidence of fraud apart from the transaction itself in order to conclude the exemption transaction was illegitimate.[3] In re Carey, 938 F.2d 1073 (10th Cir. 1991) ("[T]he desire to convert assets into exempt forms by itself does not constitute actual intent to defraud; 'extrinsic evidence of fraudulent intent is required to establish fraud.'"); In re Johnson, 880 F.2d 78 (8th Cir; 1989) (same); In re Miller, 113 B.R. 98, 104 (Bankr.D.Mass.1990) (same).

In order to determine the existence and weight of such extrinsic evidence, Courts generally apply the "Badges of Fraud" test. In re Sholdan, 217 F.3d 1006 (8th Cir. 2000) ("use of the badges of fraud is appropriate for inferring intent in an exemption case, [and] is also dictated by common sense"). A non-exclusive list of the badges includes:

- Did the debtor make the transfer after obtaining a temporary respite from the collection pressure of creditors? Matter of Reed, 700 F.2d 986 (5th Cir. 1983);

- Was credit obtained in order to purchase exempt property? See, In re Smiley, 864 F.2d 562 (7th Cir. 1989);

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[3] The standard to be applied in discharge objection cases is the same as that used to determine whether an exemption is permissible, i.e., absent extrinsic evidence of fraud, mere conversion of non-exempt property to exempt property is not fraudulent as to creditors even if the motivation behind the conversion is to place those assets beyond the reach of creditors. In re Armstrong, 931 F.2d 1233. 1239 (8th Cir. 1991); Norwest Bank Nebraska, N.A. v. Tveten, 848 F.2d 871, 874 (8th Cir.1988).

- Did the conversion occur after the entry of a judgment against the debtor? See, In re Smiley, 864 F.2d 562 (7th Cir. 1989); Ford v. Poston, 773 F.2d 52 (4th Cir. 1985); In re Swecker, 157 B.R. 694 (Bankr. M.D. Fla. 1993);

- Did the conversion occur immediately prior to the bankruptcy? See, In re Wadley, 263 B.R. 857 (2001); In re Beckman, 104 B.R. 866 (Bankr. S.D. Ohio.1989);

- Was there a sharp pattern of dealing immediately before bankruptcy? See, In re Smiley, 864 F.2d 562 (7th Cir. 1989); Compton v. Herrman (In re Herrman), 355 B.R. 287.292 (Bankr. D. Kan. 2006);

- Was the converted property of high value or were large sums of money converted into exempt forms, and the form of exempt property taken? See, In re Johnson, 880 F.2d 78 (8th Cir. 1989); Norwest Bank Nebraska, N.A. v. Tveten, 848 F.2d 871 (8th Cir.1988); but see, In re Smiley, 864 F.2d 562, 567 n.3 (7th Cir. 1989) ("we do not find a large claim of exemptions to be evidence of fraud.");

- Did the debtor misrepresent the value of assets? See, In re Johnson, 880 F.2d 78 (8th Cir. 1989); In re Smiley, 864 F.2d 562 (7th Cir. 1989); In re Smith, 113 B.R. 579, 586-87 (Bankr. D.N.D. 1990);

- Was the conversion accompanied by concealment or conduct by the debtor calculated to mislead creditors? See, In re Smiley, 864 F.2d 562 (7th Cir. 1989); In re Wadley, 263 B.R. 857 (2001).

Unfortunately, as demonstrated by the prior sampling of non-hypothetical hypotheticals, *uneven* application of this facially objective test has led to inconsistent results and subjective evaluations. See, e.g., In re Comm. Loan Corp., 396 B.R. 730 (Bankr. N.D. Ill. 2008) (Because the "badges of fraud are simply considerations," "and not an exhaustive list, no set number or combination automatically demonstrates fraudulent intent"); In re Soza, 542 F.3d 1060 (5th Cir. 2008) ("not all, or even a majority, of the 'badges of fraud' must exist to find actual fraud. Indeed, 'when several of these indicia of fraud are found, they can be a proper basis for an inference of fraud.'"); Freeland v. Enodis Corp., 540 F.3d 721 (7th Cir. 2008) ("Although '[n]o one badge of fraud constitutes a per se showing of fraudulent intent,' the presence of a number of badges of fraud 'is said to 'create . . . an overwhelming presumption of fraud' or to 'raise . . . a strong inference of fraudulent intent.'"); Voiland v. Gillissie (In re Gillissie), 215 B.R. 370 (Bankr. N.D. Ill. 1997) (when more than "half" the badges of fraud are present, there is an inference of fraud); In re Comm. Loan Corp., 396 B.R. 730 (Bankr. N.D. Ill. 2008) (when the badges of fraud are in "sufficient number," the inference of fraud may be raised).

In order to add uniformity and predictability to pre-bankruptcy planning review, the Court in Murphey v. Crater (In re Crater), 286 B.R. 756 (Bankr. D. Ariz. 2002), provided a compelling refinement of the badges of fraud test. The Court organized the badges into three categories of indicia:

1) Those which themselves indicate fraudulent or deceptive intent, i.e.: [4]
   a. The debtor retained possession or control of the property transferred after the transfer;
   b. The transfer or obligation was . . . concealed;
   c. The debtor absconded; and
   d. The debtor removed or concealed assets;"

2) Those which do not implicitly suggest fraud but do suggest there may have been a hidden motivation because the action was not "an economically rational decision" unless it was performed to hinder or delay creditors, i.e.:
   a. The transfer or obligation was to an insider;
   b. The value of the consideration received by the debtor was [not] reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
   c. The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor;

3) Those which may be innocent in themselves, or are merely timing factors that become suspicious only when combined with other factors, i.e.:[5]
   a. Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
   b. The transfer was of substantially all of the debtor's assets;
   c. The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; and
   d. The transfer occurred shortly before or shortly after a substantial debt was incurred.

The Crater Court then applied this test to the Debtors' pre-bankruptcy transactions, including, *inter alia*, the debtors' use of $40,000 in proceeds from the sale of non-exempt stock to pay down the second mortgage on their home, and filing for bankruptcy less than three weeks later, and held that alone these badges were insufficient to establish fraudulent intent -- as these badges fell within the second and third categories, and were just as indicative of the Debtors' intent to utilize available exemptions. Id. [6]

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[4] Noting that the "badges of fraud" are not codified in the Bankruptcy Code, the Crater Court used the "badges of fraud" list from the Uniform Fraudulent Transfer Act. Accordingly, certain of these badges may not necessarily be applicable to the limited circumstance of conversion of non-exempt assets into exempt assets.

[5] As to this category, the Crater Court held: "If conversion of nonexempt into exempt assets should not itself result in denial of discharge, should it do so when it occurs shortly after the debtor has been sued or incurred a large debt, or is insolvent, or is about to file bankruptcy? If that were the rule, it would mean that prospective debtors could engage in exemption planning only up until the point where it appeared they might need to do so.... [T]his would be to add a restriction to the exemption that the legislature (and Congress) did not impose, i.e., certain assets are exempt only if purchased while solvent, while not owing substantial debts, or some significant period of time prior to levy of execution or bankruptcy." Id. at 765.

[6] Although the 2005 BAPCPA amendments regarding the homestead exemption would present a different analysis under this fact pattern, the Crater analysis has been cited with approval by other Courts post-BAPCPA. See, e.g., In re Bronk, 444 B.R. 902 (Bankr. W.D. Wis. 2011); In re Glunk, 342 B.R. 717 (Bankr. E.D. PA 2006).

The Crater Court's "categorized badges of fraud" analysis appears to provide more consistent and predictable results than the relatively haphazard "traditional" badges of fraud analysis. Whether the Crater test will provide over-inclusive or under-inclusive determinations of illegitimacy is another question altogether. But there is value to reducing or eliminating "moving target" analysis from our jurisprudence. The Crater Court's poignant conclusion on this point is worthy of reiterating here:

> There are many areas of bankruptcy law where Congress apparently intended bankruptcy judges to weigh the evidence and utilize their experience and judgment to decide individual cases on a case by case basis. It does so by using terms that are inherently incapable of fine definition, such as "good faith," "substantial abuse," "undue hardship," and the like. Case law in such areas tends to identify "factors" that in reality are merely a checklist of relevant facts or issues to consider, none of which is dispositive. Perhaps such areas of bankruptcy law are best dealt with as in the civil system, with each judge reading and applying the statute and its underlying policies and principles to each factual situation that comes up, without regard to what the last judge did on different facts...
>
> *But this is not one of those areas.* Congress did not invite bankruptcy judges to grant or deny the discharge based on an amorphous, individualistic finding such as "reasonable" or "good faith." Instead, it made the requisite determination hinge on intent, something that common law precedent has successfully refined over the centuries, particularly in tort law and in criminal law. Consequently here it is appropriate for courts to seek to refine and define the requisite intent, so that the evolution of precedent may in the long run yield predictable, practical rules.
>
> And this is an area of law where that effort is particularly needed and important. As noted by the Tveten dissent, "[d]ebtors deserve more definite answers" than "each bankruptcy judge's sense of proportion." 848 F.2d at 879 (Arnold, J., dissenting). Without more definite answers, "debtors will be unable to know in advance how far the federal courts will allow them to exercise their rights under state law." Id. The result will be that some debtors who relied on well intentioned advice of counsel may be denied a discharge, the bankruptcy equivalent of the death penalty, while others receive an unconscionable benefit, perhaps through ignorance or perhaps through cunning. And as the Tveten dissent also emphasizes, for the judiciary to deny an exemption that the legislature has provided simply because the judge finds it out of proportion is to invade the province of the legislative branch. Id. at 878.

Crater, at 772 (emphasis supplied).

IV. SANCTIONS FOR IMPROPER PRE-BANKRUPTCY CONDUCT

There are a number of sanctions and remedies which Courts have imposed for a debtor's pre-bankruptcy abuse of the exemption provisions, including: the denial or limitation of an exemption; denial of discharge; Rule 9011 sanctions; avoidance of the transfer as a fraudulent conveyance; and criminal prosecution. See, Taylor v. Freeland & Kranz, 503 U.S. 638 (1992).

A. Disallowing or Limiting the Exemption

Historically, disallowing or limiting an improperly claimed exemption created via a pre-bankruptcy conversion was the norm. See, e.g., In re Levine, 134 F.3d 1046 (11th Cir. 1998); In re Gray, 498 B.R. 238 (Bankr. D. Ariz. 2013); In re Sholdan, 218 B.R. 4750 (Bankr. D. Minn. 1998). However, the ability to deny an exemption on the basis of fraud or other bad faith conduct has been called into question by the Supreme Court's decision in Law v. Siegel, 134 S. Ct. 1188 (2014). In Siegel, the Supreme Court held that a bankruptcy trustee cannot *surcharge* a legitimately claimed exemption, because bankruptcy courts may not use their equitable powers under Section 105(a) to fashion relief that violates the express terms of other sections of the Code. i.e., §522(k). However, the Siegel Court further stated, *in dicta*, that because Congress had set forth several specific basis for denying a claim of exemption, that this impliedly established that such other grounds for denying an exemption such as fraud or bad faith was statutorily unauthorized. Subsequently, some Bankruptcy Courts have held that the Siegel *dicta* must be followed, and hold that bad faith and fraud are no longer grounds for disallowing an exemption. See, e.g., In re Gray, 523 B.R. 170 (B.A.P. 9th Cir. 2014); In re Elliott, 523 B.R. 188 (B.A.P. 9th Cir. 2014); In re Mateer, 525 B.R. 559 (Bankr. D. Mass. 2015); *cf.*, In Re Dickey, 517 B.R. 5 (Bankr. D. Mass. 2014). However, the Court in In re Woolner, 2014 WL 7184042 (Bankr. E.D. Mich. 2014), held that Bankruptcy Rule 4003(b)(2) provided the necessary authority for sustaining an objection to exemption "at any time prior to one year after the closing of the case if the debtor fraudulently asserted the claim of exemption." Rule 4003(b)(2) was not discussed in Siegel, because it went into effect after the Debtor's petition date. Id.; see also, Whatley v. Stijakovich-Santilli (In re Stijakovich-Santilli), 542 B.R. 245 (BAP 9th Cir. 2015) (trustee has right to object to exemption on Debtor's fraudulent conduct under Rule 4003(b)(2)); but see, In re Bogans, 534 B.R. 346 (Bankr. W.D. Wis. 2015).

Whether disallowance of an exemption on the basis of fraud or bad faith is ultimately determined to be within the power of the Bankruptcy Court, the Supreme Court made clear that there are other remedies and sanctions available for such misconduct. Law v. Siegel, supra.

B. Denial of Discharge

A common sanction imposed for a debtor's illegitimate pre-bankruptcy planning is the denial of discharge. In re Johnson, 880 F.2d 78 (8th Cir. 1989); Norwest Bank Nebraska, N.A. v. Tveten, (8th Cir. 1988); Matter of Reed, 700 F.2d 986 (5th Cir. 1983); In re Lang, 246 B.R. 463 (Bankr. D. Mass. 2000), order aff'd, 256 B.R. 539 (B.A.P. 1st Cir. 2000). In order to impose such a sanction, the Court must find that the elements for denial of discharge set forth under Section 727 have been satisfied, typically applying the badges of fraud test. Id.

C. Imposition of Sanctions

In Taylor v. Freeland & Kronz, supra, the U.S. Supreme Court expressly held that various penalties exist for engaging in improper conduct in bankruptcy proceedings, and expressly referenced, among other civil and criminal penalties, Rule 9011 sanctions for "signing certain documents not well grounded in fact and . . . warranted by existing law or a good faith argument for the extension, modification, or reversal of existing 1aw," which includes scheduled exemptions which are not supported by the facts or the law. See, e.g., In re Lemons, 285 B.R. 327 (Bankr. W.D. Okla. 2002); In re Smith, 143 B.R. 912 (Bankr. D. Neb. 1992); Matter of Slentz, 157 B.R. 418, 420 (Bankr. N.D. Ind. 1993).

D. Transfer Avoided as a Fraudulent Conveyance

Some Courts have held that the conversion of nonexempt to exempt assets may qualify as a transfer for avoidance purposes under section 547, 548 or 550 of the Bankruptcy Code. Levine v. Weissing (In re Levine), 134 F.3d 1046 (11th Cir. 1998); In re Dunbar, 313 B.R. 430 (Bankr. C.D. Ill. 2004); In re Harry, 151 B.R. 735 (Bankr. W.D. Va. 1992); but see, In re Messina, 184 B.R. 176 (Bankr. D. Mass. 1995) (Inherent in the quoted definitions is a requirement that a "transfer" include the acquisition of an interest by a third party).

E. Criminal Penalties

Trustees and the U.S. Trustee are required to report any reasonable ground for criminal violation to the U.S. attorney. 18 U.S.C. §3057(a). 18 U.S.C. §152, imposing criminal penalties for bankruptcy fraud, may be applicable if the debtor commits fraud in the transfer or assertion of a claim of exemption. See, Taylor v. Freeland & Kronz, 503 U.S. 638 (1992).

CONCLUSION

There is uncertainty of when legitimate pre-bankruptcy planning crosses the line to a prohibited attempt to hinder, delay or defraud creditors. Cases such as Murphey v. Crater (In re Crater), 286 B.R. 756 (Bankr. D. Ariz. 2002) (categorized Badges of Fraud) are a step towards predictability, but most Courts still leave it to ad hoc weighing of the evidence.

When advising a client, it is important to look at the risk/reward involved for a particular transaction. For example, it is poor advice to a client to engage in transactions that may arguably protect $20,000.00 in non-exempt assets, and risk losing a discharge of $2,000,000.00 in debt. Matter of Swift, 3 F.3d 929 (5th Cir. 1993). When considering pre-bankruptcy planning transactions, unlike Shakespeare's Falstaff, discretion is the better part of valor.

[1] In re Mueller, 867 F.2d 568 (10th Cir. 1989) (Debtor denied personal exemption for the value of a life insurance policy).

[2] In re Wadley, 263 B.R. 857 (Bankr.S.D. Ohio 2001) (Court held transactions were permissible pre-bankruptcy exemption planning).

[3] In re Barker, 168 B.R. 773 (Bankr. M.D. Fla. 1994) (Exemption allowed, but discharge denied as Court concluded transaction was for purpose of defrauding creditors).

[4] In re Addison, 540 F.3d 805 (8th Cir. 2008)(Court held that although certain badges of fraud were present, these were due to the acts of exemption planning themselves, and that there was insufficient evidence of "extrinsic fraud" to find that Debtor intended to hinder, delay or defraud creditors).

[5] Matter of Swift, 3 F.3d 929 (5th Cir. 1993) (Debtor lost discharge of $2,000,000.00 in debt by engaging in "cute" transactions that involved approximately $20,000.00 of his estate).

[6] Hanson v. First National Bank (In re Hanson), 848 F.2d 866 (8th Cir. 1988) (court held that "the instant case falls within the myriad of cases which have permitted such a conversion").

[7] Murphey v. Crater (In re Crater), 286 B.R. 756 (Bankr.D.Ariz. 2002) (Court found that facts did not establish any improper intent to hinder, delay or defraud creditors, other than an intent to utilize available exemptions when the need to do so became evident).

[8] In Re Bronk, 444 B.R. 902 (Bankr. W.D. Wis. 2011) (no evidence of "sharp dealing." Conversion was an understandable, permissible attempt to preserve assets).

[9] Albuquerque National Bank v. Zouhar (In re Zouhar), 10 B.R. 154 at 157 (Bankr. D.N.M. 1981) (Debtor denied discharge, court concluded transaction was fraudulent as to creditors).

[10] In re Simms, 243 B.R. 156 (Bankr. S.D. Fla. 2000) (Court permitted the exemption because the trustee had not established that the conversion was done with an intent to hinder, delay, or defraud creditors).

[11] In re Carey, 96 B.R. 336 (Bankr. W.D. Okla. 1989), judgment aff'd, 112 B.R. 401 (W.D. Okla. 1989), aff'd, 938 F.2d 1073 (10th Cir. 1991) (court found in favor of the debtor because of the absence of any pre-bankruptcy concealment of her actions and her complete disclosure of all of the transactions in her bankruptcy schedules and at the section 341 hearing).

[12] Norwest Bank Nebraska v. Tveten (In re Tveten), 848 F.2d 871 (8th Cir. 1988) (discharge denied; Debtor "did not want a mere fresh start, he wants a head start").

[13] Gill v. Stern (In re Stern), 345 F.3d 1036 (9th Cir. 2003) (Court held transfer of assets to exempt pension plan not fraudulent, upholding exemption).

PROFESSIONAL RETENTION, REQUIRED DISCOSURES AND POTENTIAL CONFLICT PROBLEMS IN BANKRUTPCY CASES

Conflict issues arise frequently in the entire spectrum of bankruptcy practice, whether in a chapter 11 or 7 case, a consumer or business cases. These issues arise whether the professional is representing a debtor, a committee, or creditors or some combination thereof and whether acting as general bankruptcy counsel or special counsel. The following is intended to provide you with general information about what you need to consider when accepting a professional engagement – the basic rules and guidelines that must be followed - - and some of the common pitfalls and potential situations you may encounter and will need to navigate regarding ethics, conflicts, and potential conflicts. The overarching principle that should be followed is that one can never over-disclose when professionals provide the required disclosures related to his or her connections.

Sections 327, 1103 and 107 of the Bankruptcy Code govern the employment of professionals in connection with a bankruptcy case. Under Section 328©, the court may deny allowance of compensation for services and reimbursement of expenses to a professional employed pursuant to Sections 327 or 1103 if the court finds that at any time during the employment the professional was not a disinterested person or held or represented an interest adverse to the estate. Failure to disclose relevant connections is an independent basis for the disallowance of fees or disqualification.

The vast majority of cases in these materials where attorneys' fees are denied or ordered disgorged involves non-disclosure issues. Accordingly, it is in every professionals best interest to over disclose his or her connections. The other concept that is clear from the cases is that, when it comes to the interpretation of conflicts, the facts and circumstances of each particular case will dictate the result more than an insular consideration of the legal terms in a vacuum.

I. Employment of Professionals Under the Bankruptcy Code

A. Sections 327, 1103, and 1107 of the Bankruptcy Code govern the employment of professionals in connection with a chapter 11 case.

1. Section 327(a) provides that: "the trustee, with the court's approval, may employ one or more attorneys, … that do not hold or represent an interest adverse to the estate, and that are disinterested persons…."

2. The requirements of 11 U.S.C. 327 "serve the important policy of ensuring that all professionals appointed pursuant to [the section] tender undivided loyalty and

provide untainted advice and assistance in furtherance of their fiduciary responsibilities." *Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994).

B. The retention process is designed to ensure public confidence in the bankruptcy system, to prevent abuses, by limiting the retention of professionals only to those instances where it can be demonstrated that the services are necessary.

C. Unless the professional comes within the limited exception provided for by 11 U.S.C. 327(b), prior court approval of the employment of a professional person is necessary.

II. Application Seeking Court Approval of Employment and "Interested/ Disinterested Parties"

A. Court approval of a professional person's employment is contingent upon a finding that the applicant has met a two-pronged test: (1) the professional must be disinterested; and (2) must not hold an interest adverse to the estate. 327(a)

B. These determinations are based upon the disclosures made in the application to employ and affidavit required by Rule 2014.

C. The contents of an employment application are dictated by Fed. R. Bankr. P. 2014.

D. An application for professional services must at a minimum contain all of the following elements:

1. specific facts showing the necessity of the employment;
2. the name of the person to be employed;
3. the reasons for the selection;
4. the professional services to be rendered;
5. any proposed arrangement for compensation; and
6. all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States Trustee, or any person employed in the Office of the United States Trustee.

C. Fed. R. Bankr. P. 2014 disclosure requirements are to be strictly construed. *Rome v. Braunstein*, 19 F.3d 54, 59 (1st Cir. 1994);

D. All facts that may have any bearing on the disinterestedness of a professional must be disclosed. It is the responsibility of the professional, not of the court, to ensure that all relevant connections have been brought to light. See, e.g., *Rome v. Braunstein*, 19 F. 3d 54 (1st Cir. 1994).

E. Until such time as an order is entered authorizing employment, professionals perform services at their peril.

F. The question of whether a professional meets the standards of the law is one for the court to adjudicate after a full disclosure of the facts. *In re Leslie Fay Cos., Inc.*, 175 B.R. 525 (Bankr. S.D.N.Y. 1994).

III. **Consequences for Conflicts**

A. Actual conflicts are disqualifying: A professional's conflict of interest may render him or her ineligible to serve as a professional under 11 U.S.C. 327(a). Section 327(c) requires the presence of an actual conflict of interest; however, the statute does not define an actual conflict of interest. Whether the professional's representation is precluded is dependent on a detailed consideration of the relevant circumstances. See *In re Waterfall Village of Atlantic, Inc.*, 103 B.R. 340, 344 (actual conflict of interest renders counsel not disinterested) (Bankr. N.D. Ga. 1989).

B. Some cases also hold that potential conflicts are disqualifying: *In re: Martin*, 817 F.2d 175 (1st Cir. 1987).

C. Other cases find a presumption of sorts that a potential conflict will ripen into an actual conflict and have found potential conflicts disqualifying. *In re BH&P, Inc.,* 949 F.2d 1300 (3rd Cir. 1991); *In re BH&P Inc*., 949 F.2d 1300 (3d Cir. 1991); and *In re American Printers & Lithographers, Inc.*, 148 B.R. 862 (N.D. Ill. 1992). *In re Stanford Color Photo, Inc.*, 98 B.R. 135, 137-38 (Bankr. D. Conn. 1989); See also *Matter of Codesco, Inc.*, 18 B.R. 997, 999 (Bankr. S.D.N.Y. 1982) (potential conflict renders counsel disinterested) ; *In re Proof of the Pudding, Inc*., 3 B.R. 645, 647 (Bankr. S.D.N.Y. 1980); see also *In re Bohack Corp.*, 607 F.2d 258, 263 (2d Cir. 1979).

IV. **Consequences for Failure to Disclose**

A. Under Section 328(c), the court may deny allowance of compensation for services and reimbursement of expenses to a professional employed pursuant to Sections 327 or 1103 if the court finds that at any time during the employment the professional was not a disinterested person or held or represented an interest adverse to the estate.

B. In *In re Granite Partners, L.P.*, 219 B.R. 22 (Bankr. S.D.N.Y. 1998), the bankruptcy court found that the law firm retained by the chapter 11 trustee represented potentially adverse interests to the estate relating to investigative work undertaken at the trustee's request and that the law firm had failed to disclose same to the court. In admonishing the law firm, the court noted the necessitation of imposing a severe sanction, i.e., significantly reducing the requested compensation. (Although the court acknowledged that an independent examiner concluded that no harm had been inflicted on the estate, the willfulness exhibited by the law firm's flagrant non-disclosure required the sanction).

C. Failure to disclose relevant connections is an independent basis for the disallowance of fees or disqualification. See *In re Futuronics Corp.*, 655 F.2d 463, 469 (2d Cir. 1981), cert. denied, 455 U.S. 941 (1982); *In re Arlan's Dep't Stores, Inc.*, 615 F.2d at 933; *Rome v. Braunstein*, 19 F.3d at 59; *In re Leslie Fay Cos., Inc.*, 175 B.R. 525 (Bankr. S.D.N.Y. 1994); *In re Granite Sheet Metal Works, Inc.*, 159 B.R. 840, 847 (Bankr. S.D.

Ill. 1993); *In re Diamond Mortgage Corp.*, 135 B.R. 78 (Bankr. N.D. Ill. 1996). *In re Envirodyne Indus., Inc.*, 150 B.R. 1008, 1021 (Bankr. N.D. Ill. 1993); *Neben & Starrett v. Chartwell Financial Corporation* (*In re Park-Helena Corp.*), 63 F.3d 877 (9th Cir. 1995) (attorneys willful failure to disclose source of retainer resulted in complete denial of fee application); *Law Offices of Nicholas A. Franke v. Tiffany* (*In re Lewis*), 113 F.3d 1040 (9th Cir. 1997) (disgorgement ordered for false statement that entire $40,000 retainer was paid prepetition when in fact $30,000 was paid postpetition); *United States v. Schilling* (*In re Big Rivers Electric Corporation*), 355 F.3d 415 (6th Cir 2004)(examiner required to disgorge fees; examiner was not disinterested when he negotiated fee arrangement with creditors, linking recovery with success fee; examiner failed to disclose arrangement); *In re Jore Corporation*, 298 B.R. 703 (Bankr. D. Mont. 2003) (law firm's failure to disclose limitation on DIP's lender's waiver of conflict of interest resulted in disgorgement of fees).

V. **Employment of special counsel**

A. An attorney that has represented the debtor and who therefore may be ineligible for employment under 11 U.S.C. 327(a) may be hired under 11 U.S.C. 327(e) if the employment is for a specified special purpose (other than general conduct of the case), provided that the employment is in the best interest of the estate and the attorney does not hold or represent an interest adverse to the estate *with respect to the particular matter for which such attorney is employed*.

B. Can the restrictions of 327(a) be avoiding by seeking employment as special counsel under 327(e) when services are more akin to really general bankruptcy counsel services and 327(a). *In re Running Horse, L.L.C.*, 371 B.R. 446 (E.D. Cal. 2007) (court denied debtor's application to employ lawyer as "special counsel" under § 327(e) when duties are too close to general bankruptcy counsel under § 327(a), and counsel represented other parties and was therefore not disinterested); *But see, In re Woodworkers Warehouse, Inc.*, 323 B.R. 403 (D. Del. 2005) (bankruptcy court disqualified law firm under 327(a) for lack of disinterestedness, debtor moved to employ same firm as "special counsel" for specific tasks (*e.g.,* cash collateral, going out of business sale, negotiating KERP). UST objected to new application as circumvention of disinterestedness restrictions of 327(a). Court overruled objection finding the stated services were not conducting the case within meaning of 327(e).

C. Note that 11 U.S.C. 327(e) applies only to attorneys. Accountants and other professional persons are not eligible for employment pursuant to that section. *In re Andover Togs, Inc.,* 2001 U.S. Dist. LEXIS 2690 (S.D.N.Y. 2001).

D. Moreover, at least one district court in parsing the statute has required counsel to have been formerly employed by the debtor. See *Meespierson v. Strategic Telecom, Inc.*, 202 B.R. 845 (D. Del. 1996).

VI. **Committee professionals**

A. Section 1103(a) of the Bankruptcy Code authorizes official committees to employ, subject to court approval, attorneys, accountants, or other agents.

B. Under Section 1103(b), an attorney or accountant employed by a committee may not represent any other entity having an adverse interest in connection with the case.

1. Representation of a creditor of the class represented by the committee does not constitute a *per se* conflict.

2. In *In re Whitman*, 101 B.R. 37 (N.D. Ind. 1989) court held that lawyer could not represent the creditors' committee and a secured creditor, but gave lawyer option to terminate one representation and continue the other.

VII. State Ethical Considerations

A. A court's determination of disinterestedness pursuant to Section 327(a) does not obviate the necessity of determining that conflicts of interest does not exist under other applicable laws and regulations, including the codes of professional ethics governing attorney conduct in each state.

B. Mode Rule of Professional Conduct Rule 1.7. Attorneys cannot accept representation of a client whose interest is directly adverse to those of an existing client unless, among other requirements, the attorney reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client and the attorney obtains informed consent from the affected clients.

C. Model Rule of Professional Conduct 1.9. A lawyer that has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent confirmed in writing.

VIII. Potentially Problematic Representations

A. Relationship to Insider of Debtor

1. Courts in certain circumstances have found professionals not disinterested due to close relationships with insiders of the Debtor, because, among other concerns, insiders are often creditors or targets of investigations by the debtors.

2. Concurrent representation of insider may provide cause for disqualification or denial of compensation if not disclosed.

- *In re Big Mac Marine, Inc*., 326 B.R. 150 (B.A.P. 8th Cir. 2005) (affirming order denying motion to vacate prior order denying chapter 11 debtor's application to retain attorney because attorney simultaneously represented debtor's principals in their individual bankruptcy proceedings, which created an actual conflict of interest).

- *In re Von Behren Electric*, 2001 Bankr. Lexis 1463 (C.D. Ill. 2002)(Court denied compensation to Debtor's counsel because it found that counsel had put the interest of debtor's principals over

that of the debtor in its separate representation of debtor's principals).

- In re R&R Associates of Hampton, 402 F.3d 257 (1st Cir. 2005)(law firm liable for malpractice by breaching fiduciary duties to estate and for its failure to properly disclose prior relationships when simultaneously representing bankruptcy estate and its individual general partners and assisting the individual partners in insulating their assets from creditors).

- *In re Freedom Solar Center, Inc.,* 776 F.2d 14 (1st Cir. 1985) *(*on appeal, First Circuit Court reversed order permitting attorney to continue to represent debtor, debtor's sole shareholder, and a new corporation organized by shareholder, and where shareholder might be liable for preferential transfers).

- *In re Water's Edge Limited Partnership*, 251 B.R. 1 (D. Mass. 2000). Creditor moved to disqualify counsel that had previously represented individual closely related to debtor and who had tried to gain control of debtor. Court allowed representation holding that law firm was not disqualified based upon prior representation of alleged insider who provided funding for plan.

3. Concurrent Representation of Multiple Debtors.

- *In re Adelphia Communications Corp*., 336 B.R. 610 (S.D.N.Y. 2006). Law firm filed application to represent 230 debtors, all related to main debtor Adelphia in Chapter 11. Certain creditors objected and moved to disqualify. Bankruptcy court held that law firm would have to step aside during resolution of inter-debtor disputes. The district judge affirmed at In re Adelphia Communications Corp., 342 B.R. 122 (S.D.N.Y. 2006).

- *But see, In Re Coal River Resources, Inc.*, 321 B.R. 184 (W.D.Va. 2005) Debtors in four jointly administered cases filed application to employ same law firm. District court affirmed bankruptcy court ruled that firm could represent only two of debtors because of inter-company debts and differing accounting methods).
- *And In re JMK Contruction Group, Ltd,* 441 B.R. 222 (Bankr. S.D.N.Y. 2010) Court denied application of multiple related debtors to retain same law firm because debtors had potential contribution and other pre-petition claims against each other).

4. Prior representation of an insider may provide cause for disqualification or denial of compensation.

- *In re Angelika Films 57th, Inc.* 227 B.R. 29 (Bank.S.D.N.Y. 1998) (Court denied fee application of debtor's counsel primarily based upon the fact that Debtor's counsel filed a motion seeking to sell a lease at a below market price to debtor's majority shareholder who previously had been represented by debtor's counsel).

- *Rome V. Braunstein*, 19 F.3d 54 (1st Cir. 1994) denying fee application of debtor's counsel that previously represented both sole shareholder, president of the debtor and certain of his other family members);

- *In re EZ links Golf, LLC*, 317 B.R. 858 (Bankr. D. Colo. 2004) (denying retention of debtor's proposed counsel because it had close ties and consequential relationships with parties that were inseparable with the debtor).

- *But see, In re Jade Management Services,* 386 Fed.Appx. 145 (3d Cir. 2010) (not selected for publication in Federal Reporter) (debtor's counsel also represented sole shareholder, who had guaranteed all of debtor's secured debt. Party in interest objected to fees. Bankruptcy court approved fees saying conflict was only potential because of likelihood that assets would be sufficient to cover secured claims and wouldn't need to look to shareholder to cover shortfall. District and appellate courts affirmed on appeal stating within bankruptcy courts discretion)

5. Entities with aligned interest, common owner, no harm

    - *In re Universal Enterprises of W. Va.,2010 WL 2403354 (Bankr.N.D. W.Va. 2010)(not reported in BR)* (debtor is owner of commercial real estate leased to automobile dealer. Same individual owns both companies. Debtor filed application to employ lawyer, who represents auto dealer. Creditor objected. Court granted app, stating conflict not disqualifying because continued success of lease was in best interests of estate that debtor and auto dealer's interest were aligned.

    - *In re Gregory & Parker, Inc.*, slip copy 2013 Bankr. LEXIS 1206 (E.D.NC. 2013) (Corporate debtor in one bankruptcy, sole shareholder and spouse are in another. Both sought to hire same counsel to pursue adversary proceeding. Court approved stating that although general counsel could not be general counsel in both cases, in adversarial proceeding, debtors' interests are aligned so no conflict)

    - *In re Hummer Transportation,* slip copy 2014 WL 412534 *(E.D.Cal. 2014)* (bankruptcy court and district court approved retention of attorney by chapter 7 trustee to handle malpractice claim when attorney had previously represented personal injury plaintiffs in suit against debtor noting lawyer was not a creditor and that the interests of the trustee and the plaintiffs were aligned, so no conflict).

6. Whether attorney for chapter 7 debtor can also represent non-debtor defendant in adversary proceeding brought by debtor's chapter 7 trustee

- *In re Morey*, 416 B.R. 364 (Bankr. D. Mass. 2009) (Bankruptcy court disqualified debtor's attorney from representation of debtor's non-filing ex-spouse in fraudulent conveyance adversary proceeding. Court found that debtor has duty of cooperation to the trustee and counsel could not adequately assist debtor with duty of cooperation while simultaneously representing defendant whose interests are adverse to the trustee in an adversary proceeding brought by trustee).

- The Morey case cited other cases referenced considering similar issues of simultaneous representation. A similar case is *In re Inghram v. Hays,* 2008 WL 514999 (Bankr. C.D. IL. 2008) (not reported in Bankruptcy Reporter) (debtor's attorney should not represent debtor's boyfriend against whom trustee had fraudulent transfer claims because presented clear conflict of interest).

B. Malpractice Claims

1. Failure to properly disclose relationships may form basis for a malpractice claim against party representing the debtor.

    - *In re Sonic Blue Inc., et. al,* (Bankr N.D. Cal. 2009)(approving $10 million Settlement of malpractice action against debtor's general bankruptcy counsel for breach of fiduciary duty based on failure to disclose disqualifying conflict of interest).

2. Does Approval of Fee Application Preclude legal malpractice claim, because court must make implicit finding as to quality and value of services when it awards fees.

    - *In Re Iannochino*, 242 F3d 36 (1st Cir. 2001) (the First Circuit Court of Appeals held that because all of the elements of res judicata were present, the bankruptcy court correctly ruled that debtor's malpractice claim, which should have been raised as a compulsory counterclaim at the time the fee application was filed, was barred by prior approval of fee application).

    - *See also Grausz v. Englander*, 321 F.2d 467 (4th Cir. 2003) (Fourth Circuit on *de novo* review affirmed district court finding that debtor's malpractice action against his former lawyer in chapter 11 case was barred by res judicata based upon the bankruptcy order approving the lawyer's interim and final fee applications, without objection by debtor. Note that case had originally been brought in state court, but lawyer had removed to district court pursuant to "arising in " jurisdiction under 28 USC § 1334(b)).

- *See also In the Matter of Intelogic Trace, Inc.*, 200 F.3d 382 (5th Cir. 2000) (5th Circuit affirmed – Chapter 7 trustee had brought AP against accountants who had represented debtor in prior chapter 11. Bankruptcy court granted summary judgment to defendants based on *res judicata* effect of order granting fees. District Court and Court of Appeals affirmed. Debtor's board had concerns about fees at time of fee app, but rather than object, negotiated reduction in fees.)

- *But see In re Clement v. Brumfield*, 2004 WL 188275 (Court of App, 5th Dist. Calif.) (not reported in California Reporter) (Former chapter 11 debtor sued counsel in state court for malpractice stemming from representation in chapter 11. State trial court granted summary judgment to attorney stating former debtor did not have standing to sue and was collaterally estopped from asserting malpractice claim. On appeal, state appellate court ruled fee award in bankruptcy case was not *res judicata*, distinguishing *Iannochino* and *Grausz* cases because both counsel had withdrawn prior to fee app, and specifically distinguished the *Iannochino* case, because debtors had objected to fee app through successor counsel. In this case, counsel accused of malpractice was attorney of record from petition to closing. Also ruled if debtor lacked standing because chapter 11 plan vested assets in liquidating trustee, that was Q of fact so summary judgment in appropriate.