

In the United States Bankruptcy Court
for the Northern District of Iowa
Western Division

DIRECT TRANSIT INC.
Debtor(s).

Bankruptcy No. 96-52691XS
Chapter 11

**DECISION RE: ACCURACY OF ACCOUNTANT'S EMPLOYMENT
AFFIDAVIT AND ACCOUNTANT'S APPLICATION FOR FEES**

Two matters are before the court for consideration. One, raised by the court, is the accuracy of the affidavit executed by Coopers & Lybrand L.L.P. in support of debtor's application to employ it as accountant. Second, is the accountant's application for allowance of interim compensation. These are core proceedings under 28 U.S.C. § 157(b)(2)(A). Hearing on the affidavit was held May 22, 1997 in Sioux City. Robert S. Paul, a partner, was present on behalf of Coopers & Lybrand. David S. Heller, John R. Weiss, and A. Frank Baron appeared for the debtor. Stephen E. Garcia appeared for the official committee for general unsecured creditors. Tracy Treger and Wil L. Forker appeared for the official committee for equipment lessor creditors.

No hearing was set on the application for fees. Notice of Coopers & Lybrand's application was served on all parties. No objections were filed.

Direct Transit, Inc. filed its chapter 11 petition on October 21, 1996. On that date, it filed a motion to retain Coopers & Lybrand L.L.P. (Coopers & Lybrand) as its accountants. In support of its application, the debtor filed the Affidavit of Robert S. Paul, executed by him on October 18, 1996 (attachment to docket no. 7).

Paul's affidavit stated:

5. Neither I, Coopers & Lybrand, nor any employee of Coopers & Lybrand has any connection with the Debtor in this case, its creditors, or any other party in interest, or their respective attorneys, except as set forth therein.

6. Coopers & Lybrand has rendered accounting services to the Debtor since 1992. Coopers & Lybrand has assisted the Debtor in analyzing the Debtor's business operations, in auditing the Debtor's financial statements, in preparing certain tax returns, and in preparing for the filing of this bankruptcy estate.

Exhibit A. On October 22, 1996, I signed an order authorizing the retention of Coopers & Lybrand by the debtor-in-possession. The order included findings that the Paul affidavit complied with the Bankruptcy Code and the Rules, that Coopers & Lybrand neither held nor represented any interests adverse to the estate, that the accountant was disinterested and that its employment by the debtor-in-

possession was in the best interest of the debtor, its estate and creditors (Order, docket no. 17). The order was based in part on the affidavit.

When Direct Transit filed its petition, Charles G. Peterson was the corporation's sole shareholder, sole director and president. During a hearing on March 17, 1997, Peterson testified that Coopers & Lybrand had been his personal accountant since 1992. Because Peterson's testimony contradicted Paul's affidavit in support of the retention of Coopers & Lybrand, I scheduled a hearing to inquire into the accuracy of the affidavit. The hearing eventually took place on May 22, 1997.

At the hearing, Paul testified that Peterson had never been a client of Coopers & Lybrand, but that the accountancy firm had prepared Peterson's income tax returns and financial statements. He said the tax returns were prepared at the request of Direct Transit and paid for by it because of the corporation's Subchapter S status. The financial statements were prepared at Direct Transit's request because they were necessary to obtain Peterson-guaranteed credit for the corporation.

Paul testified that Coopers & Lybrand has always considered that its client was Direct Transit and not Peterson and that work was done for Peterson only at the client's request.

Prior to the hearing, Coopers & Lybrand filed a "Supplementary Affidavit of Robert S. Paul" (Exhibit C). Information was provided on the connections between Coopers & Lybrand and Peterson, his wife and other Peterson entities. The affidavit disclosed the preparation of the Peterson tax returns and financial statements.

The supplementary affidavit disclosed also that Coopers & Lybrand had prepared the 1994, 1995 and 1996 tax returns for Greater Development Company, Inc. (Exhibit C, 4g). The company, owned by Charles G. Peterson, leased real estate to the debtor.

The supplementary affidavit disclosed that in 1994 and 1995, Coopers & Lybrand represented Charles and Sandra Peterson before the IRS on their 1989, 1990 and 1991 taxes (Exhibit C, 4h). The express and implied reason for representing Petersons on these and other tax matters was that the debtor's tax affairs were inextricably bound up with the Petersons' because of the corporation's Subchapter S status.

After the filing of Direct Transit's bankruptcy petition, Coopers & Lybrand prepared a federal income tax return for Flatland Holding, Inc. According to the supplementary affidavit, Coopers & Lybrand first learned about Flatland in December 1996. At that time, Charles Peterson told John Uhrich of Coopers & Lybrand's Omaha office that Flatland was a corporation owned by his son Jason. Jason Peterson was an employee of the debtor. In March 1997, the official committee of general unsecured creditors filed objections to the debtor's proposed compromise of claims against Flatland. The committee alleged that certain pre-petition transfers from debtor to Flatland were fraudulent. See Committee's Resistance, docket no. 476.

Section 327(a) permits a trustee, with the court's approval, to employ an accountant, but one which does "not hold or represent an interest adverse to the estate" and one which is disinterested. A debtor-in-possession in a chapter 11 case has the same right. 11 U.S.C. § 1107(a). The trustee or a debtor-in-possession must apply to the court for an order approving the appointment of an accountant. Fed.R.Bankr.P. 2014(a). Under the Rule, "[t]he application shall be accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee." Fed.R.Bankr.P. 2014(a).

The word "connections" is not defined. Its coverage is broad and perhaps sometimes burdensome. Nonetheless, courts strictly construe the requirement that connections be disclosed. In re Leslie Fay Companies, Inc., 175 B.R. 525, 533 (Bankr. S.D. N.Y. 1994); In re EWC, Inc., 138 B.R. 276, 280 (Bankr. W.D. Okla. 1992); see also In re Begun, 162 B.R. 168, 177 (Bankr. N.D. Ill. 1993) (professional is under "definitive, affirmative duty" to disclose all connections). It is the professional's responsibility to make sure that all relevant connections are disclosed. In re Leslie Fay Companies, Inc., id. at 533.

The purpose of Rule 2014(a) is to ensure that all facts that may be relevant to the determination of professional qualification are before the Court and "to permit the Court and parties in interest to determine whether the connection disqualifies the applicant from the employment sought, or whether further inquiry should be made before deciding whether to approve the employment.

In re Begun, 162 B.R. at 177, *quoting In re Granite Sheet Metal Works, Inc.*, 159 B.R. 840, 845 (Bankr. S.D. Ill. 1993).

Following the March hearing at which Charles Peterson portrayed himself as a client of Coopers & Lybrand, attorneys for the debtor and for the official committees conducted investigations of their own as to the connections between Coopers & Lybrand and Peterson and Peterson-related entities. They describe their investigations as thorough. All agree that Coopers & Lybrand should not now be disqualified as an accountant for the debtor. They say that they are satisfied that Coopers & Lybrand is disinterested within the meaning of the Code (11 U.S.C. § 101(14)) and that it does not hold any interest adverse to the estate. It is also agreed that Coopers & Lybrand has performed valuable work for the debtor and the bankruptcy estate.

They also unanimously agree that the connections between Coopers & Lybrand and Petersons and others should have been disclosed at the time of the employment application. Since March, these attorneys have spent 55.5 hours investigating the connections between Coopers & Lybrand and parties related to the debtor. They have been compensated by the debtor for this work in the aggregate amount of \$12,625.50.

I agree with the assessment of counsel for the debtor and the committees. The employment affidavit filed by Coopers & Lybrand at the time of its employment was incomplete and failed to meet the requirement of Rule 2014(a) that the applicant disclose its connections with creditors or any other party-in-interest. Disclosure of the relationship with Petersons was necessary for interested parties to satisfactorily evaluate the accountant's fitness for appointment. That evaluation should be performed at the outset of the employment, not in the middle of the case after the accountant has performed substantial duties. In this case, these duties included the examination of the tax ramifications of a sale of substantially all assets and the revocation of Subchapter S status for the debtor.

Counsel for the debtor and the committees, after a thorough investigation, agree that Coopers & Lybrand should not be disqualified for employment. No disqualification will be ordered.

However, sanctions will be imposed for Coopers & Lybrand's failure to disclose all connections between it and Petersons and Peterson-related entities. Denial of fees is an appropriate sanction for failure to adequately disclose under Rule 2014(a). Pierce v. Aetna Life Ins. Co. (In re Pierce), 809 F.2d 1356, 1363 (8th Cir. 1987); In re Leslie Fay Companies, Inc., 175 B.R. 525, 533 (Bankr. S.D. N.Y. 1994); In re EWC, Inc., 138 B.R. 276, 280 (Bankr. W.D. Okla. 1992); In re B.E.S. Concrete

Products, Inc., 93 B.R. 228, 237 (Bankr. E.D. Cal. 1988). "Negligent omissions do not vitiate the failure to disclose." Id.

Coopers & Lybrand has filed an application for allowance of fees and reimbursement of expenses. It seeks fees from its appointment through March 24, 1997 in the amount of \$151,018.50 and reimbursement of expenses in the amount of \$4,691.45. Considering this application, I conclude that an appropriate sanction for the failure to disclose is \$25,000.00. Of that amount, \$12,625.50 merely makes the estate whole, as the debtor has paid that much in fees to its counsel and counsel for the official committees for their investigations of Coopers & Lybrand's connections or relationships to parties-in-interest. The court considers it only fair that the estate and its creditors should not have to bear that cost, and that it be placed at its source--Coopers & Lybrand. Accordingly

IT IS ORDERED that Coopers & Lybrand L.L.P. is sanctioned \$25,000.00 for failure to disclose adequately under Rule 2014(a) its pre-petition connections to Charles G. Peterson and other parties-in-interest.

IT IS FURTHER ORDERED that Coopers & Lybrand is allowed professional fees and reimbursed expenses in the amount of \$155,709.95. The amount of the sanction will be subtracted from this allowance of fees. The amount of the award is, therefore, reduced to \$130,709.95. Coopers & Lybrand may apply its retainer (\$100,000.00) to this amount, leaving an unpaid balance of \$30,709.95.

IT IS FURTHER ORDERED that debtor shall have 14 days to pay the balance of the award.

SO ORDERED THIS 25th DAY OF SEPTEMBER 1997.

William L. Edmonds
Chief Bankruptcy Judge

I certify that on I mailed a copy of this order and a judgment by U.S. mail to counsel for debtor, counsel for unsecured creditors committees, Coopers & Lybrand, 2002 list, and U.S. Trustee.