

In the United States Bankruptcy Court

for the Southern District of Iowa

THEODORE BURGHOFF

Debtor(s).

Bankruptcy No. 05-10947

Chapter 7

ANITA SHODEEN Trustee
in Bankruptcy for Theodore Burghoff

Plaintiff(s)

Adversary No. 06-30153

vs.

JOHN PETIT

Defendant(s)

ORDER RE: MOTION TO REMOVE ATTORNEYS FOR THE TRUSTEE

This matter came before the undersigned on November 7, 2006 on Defendant's Motion to Remove Attorneys for the Trustee. Peter S. Cannon appeared for Defendant John Petit. Jay B. Marcus and John Courtade appeared for Trustee Anita Shodeen. After the presentation of evidence and argument, the Court took the matter under advisement. The time for filing briefs has now passed and this matter is ready for resolution. This is a core proceeding pursuant to 28 U.S.C. §157(b)(2)(A).

STATEMENT OF THE CASE

While representing creditors in a prepetition state court action against Debtor, attorneys Jay Marcus and John Courtade engaged in an investigation into a series of allegedly fraudulent transfers in which Defendant Petit may have received up to \$300,000.00 from Debtor. After Debtor filed his Chapter 7 petition, Trustee requested permission from the Bankruptcy Court for the Southern District of Iowa to employ attorneys as special counsel for the specific purpose of continuing to investigate Defendant in order to recover any fraudulently conveyed assets belonging to the estate. The court approved the requested employment.

Defendant now requests the removal of Attorneys Marcus and Courtade as counsel for Trustee. He alleges that they are disqualified from representing Trustee because they are still actively representing creditors of the estate and failed to disclose numerous conflicts.

Trustee asserts that the undisclosed information to which Defendant refers is irrelevant and not required to be disclosed under the Bankruptcy Code. Trustee claims Defendant's objections are an attempt to prevent the most knowledgeable attorneys from pursuing claims against him and has requested sanctions if the Court denies Defendant's motion to remove counsel.

FINDINGS OF FACT

Defendant and Debtor were partners in an investment and securities trading business. In 1993, Michael and Charlotte Cain formed a separate investment partnership with Debtor, referred to as Speed Diamond Co. Over the span of a decade, Debtor allegedly misappropriated the Cains' investment funds for his personal use and for various other investment schemes. The Cains filed suit against Debtor in the Iowa District Court for Jefferson County. The Jefferson

County court granted the Cains summary judgment on several causes of action, including breach of fiduciary duty, breach of contract, conversion of property, and negligence. The judgment awarded \$131,436.00 in damages and left open the possibility for the Cains to recover further damages resulting from Debtor's misrepresentations.

During the course of the Cains' suit against Debtor, they discovered that Debtor may have transferred about \$300,000.00 to Defendant in November and December of 2000. Subsequent investigation also revealed that Defendant may hold other funds for Debtor's benefit. Based upon this information, the Cains filed suit against Defendant in Jefferson County.

About a month after the Cains obtained summary judgment against Debtor, he filed for Chapter 7 bankruptcy. The Cains refiled their claim against Debtor as an adversary action. Mr. Marcus continued to represent the Cains throughout this time period. He also alerted Trustee of the Cains' cause of action against Defendant.

At the hearing regarding Defendant's motion to remove counsel, Mr. Marcus testified that his discussions with Trustee regarding the claim against Defendant focused on the extensive analysis of financial documents and conflicting deposition testimony offered by Defendant and Debtor. The parties decided that since Mr. Marcus and Mr. Courtade had already conducted much of this analysis in connection with their prior representation of the Cains, it would help conserve the resources of the estate if Mr. Marcus and Mr. Courtade represented Trustee as special counsel in the adversary action against Defendant. Trustee and Attorneys Marcus and Courtade (hereinafter "Special Counsel") agreed that concurrent representation of the Cains and Trustee presented a potential conflict of interest. To avoid such a conflict, Mr. Marcus procured a claim assignment from the Cains, through which they assigned their right to pursue Defendant to Trustee. Because there is almost no money in the estate, Special Counsel's compensation is contingent upon recovery in the potential litigation.

Trustee's application to appoint Special Counsel discloses that Special Counsel had previously represented the Cains, now creditors of the estate. (Def.'s Ex. 2.) The application states that the parties had evaluated "various legal arguments and the current status of the litigation" and "determined that this employment is in the best interest of the estate due to the experience and involvement of the prior counsel in this case." Id. Trustee's application further discloses the Cains' assignment of their claim to the estate and that "any recovery will be turned over in its entirety to the bankruptcy estate for administration pursuant to the Code." Id. The application also discloses the contingent nature of Special Counsel's compensation.

At the hearing on the motion to remove Special Counsel, Defendant asserted two reasons that might justify Special Counsel's disqualification from representing Trustee. First, Defendant claims Special Counsel's concurrent representation of the Trustee and the Cains presents a conflict of interest which singularly disqualifies them from representing Trustee. Defendant further alleges that Special Counsel did not cure this conflict when they obtained the alleged assignment of the Cains' right to pursue action against Defendant. Mr. Marcus' trial testimony indicated he was unsure what would happen to the Cains' claim if the Trustee did not pursue it. Thus Defendant theorizes that the Cains could not have given informed consent when they agreed to the assignment because Mr. Marcus did not adequately explain all of their options to them -- particularly the right to independently pursue Trustee's abandoned claims.

Next Defendant asserts that the strict disclosure requirements of the Rules of Bankruptcy Procedure were not followed in Trustee's application to appoint Special Counsel. First, Defendant alleges that Trustee failed to follow proper procedure because Defendant never received notice of Trustee's application to appoint Special Counsel. Further, Defendant states that Mr. Marcus is listed as a creditor in Debtor's Chapter 7 schedules and this information should have been disclosed. Additionally, Defendant asserts that Mr. Marcus should have disclosed that he formerly represented a client against Primus Communications, a telephone company that is a creditor in this case. Mr. Marcus also did not disclose that he had previously requested a court to sanction a company represented by another creditor in this case, the Foss Firm. Finally, Defendant alleges that Special Counsel should have disclosed the full extent of the actions they have taken on behalf of the Cains, namely that they have also taken action against the Debtor's former principal, the Walker Group.

Trustee and Special Counsel respond that they disclosed all relevant connections required under the Bankruptcy Code. Special Counsel asserts that Mr. Marcus is not a creditor and was erroneously listed as such in Debtor's Chapter 7

petition. Special Counsel first points to the fact that Debtor lists the amount owed to Mr. Marcus as \$0.00. Special Counsel explains that due to a contingency fee arrangement, Mr. Marcus may become a creditor of the Cains if they recover from Debtor; however this does not make Mr. Marcus a creditor of Debtor.

Special Counsel further responds that the suit against Primus, a creditor in this case, occurred several years ago and involved a dispute over \$200 in unpaid telephone bills. Special Counsel asserts that such an action is not a connection required to be disclosed under the Code.

As to Defendant's allegations that Mr. Marcus requested sanctions against the Foss Firm, another creditor in this case, Mr. Marcus responds that a request for discovery sanctions was made against the defendant in that case and its national counsel in Philadelphia, not against its local Iowa counsel, the Foss Firm.

Special Counsel also assert that they were not required to disclose the suit they filed on behalf of the Cains against Debtor's former employer, the Walker Group. The Walker Group is not a creditor or party in interest and thus no connection exists which would require disclosure.

Finally, Special Counsel argues that Defendant's challenge to the validity of the Cains' assignment lacks merit. Special Counsel asserts that the Cains and Trustee are the parties to the assignment and Defendant lacks standing to attack its validity. Additionally, Special Counsel states that though the bankruptcy rules do not require an assignment to be in any particular form, Counsel agreed to the assignment on behalf of the Cains, and acted with actual and apparent authority to do so. At trial, Mr. Marcus testified that he discussed the assignment with the Cains on several occasions. According to Mr. Marcus, the parties agreed that it would be strategically advantageous to have Trustee concurrently pursue the interrelated claims against Defendant and Debtor. Once the Cains agreed to the assignment, he informed Trustee and the parties proceeded with the application to appoint Special Counsel.

EVIDENTIARY ISSUES

Trustee and Special Counsel attempted to introduce as evidence a document entitled "Assignment" which purports to memorialize the Cains' transfer of their claims against John Petit to the estate. (Pl.'s Ex. 10.) Defendant objected to admission of this evidence on grounds of authentication and hearsay.

Authenticity of evidence is "a condition precedent to admissibility" and is "satisfied by evidence sufficient to support a finding that the matter in question is what its proponent claims." Fed. R. Evid. 901. Hearsay is "a statement, other than one made by the declarant while testifying at the trial or hearing, offered in evidence to prove the truth of the matter asserted." Fed. R. Evid. 801(c).

The Court conditionally accepted Exhibit 10 into evidence in order to provide Special Counsel the opportunity to lay grounds for its admittance. The Cains were not called to testify at the hearing and no other method of authenticating the document was presented to the Court. Special Counsel have not asserted any applicable exception to the hearsay rule in this instance, nor can the Court discern any applicable exception. Accordingly, Exhibit 10 is inadmissible.

CONCLUSIONS OF LAW

Under § 327(a) of the Bankruptcy Code, the trustee of a Chapter 7 estate "with the court's approval, may employ one or more attorneys . . . to represent or assist the trustee in carrying out the trustee's duties." 11 U.S.C. § 327(a). Section 327(a) lists two preconditions for employment of professionals by the estate. First, the chosen professional must not hold or represent an interest adverse to the estate. *Id.* Second, the professional must be a disinterested person. *Id.*

The meaning of an adverse interest has been developed by case law. Courts traditionally define an interest adverse to the estate as "any economic interest that would tend to lessen the value of the bankruptcy estate or that would create an actual or potential dispute in which the estate is a rival claimant." *In re Premier Farms, L.C.*, 305 B.R. 717, 720 (Bankr. N.D. Iowa 2003).

On the other hand, the Bankruptcy Code clearly defines who may qualify as a "disinterested person." *See* 11 U.S.C.

§101(14)(E). The definition, in relevant part, states that a disinterested person "does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor . . . or for any other reason." Id.

The requirement of disinterestedness under §327(a) is subject to certain exceptions. For instance, §327(c) clarifies that a professional "is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is an objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest." 11 U.S.C. § 327(c). Thus §327(c) permits a trustee to employ non-disinterested persons as counsel as long as the only reason for the lack of disinterestedness is counsel's representation of a creditor. Id.

The second exception to the requirement of disinterestedness applies to situations where a trustee seeks to employ a debtor's counsel for a special purpose. Under § 327(e) and with court approval, a trustee may employ for a special purpose, "other than to represent the trustee in conducting the case, an attorney who has represented the debtor . . . if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed." 11 U.S.C. § 327(c).

Federal Rule of Bankruptcy Procedure 2014 regulates the trustee's application for employment of a professional person under § 327. Rule 2014 states that the application for employment should include details such as the identity of the person to be employed, the factors which necessitate the need for employment, and the proposed method of compensation. Fed. R. Bankr. P. 2014. Under this 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 and any other party in interest." Id. Generally, there is no requirement for either notice or hearing with respect to the employment of professional person by a trustee; however, the bankruptcy court has discretion to order a noticed hearing. In re Crest Mirror & Door, Inc., 57 B.R. 830, 831-32 (B.A.P. 9th Cir. 1986); In re Land, 116 B.R. 798, 800 (D. Colo. 1990).

The word "connections" is not defined within Rule 2014. However, the purpose of § 327 is to "prevent the estate from being represented by people who might have some interest or relationship that would color the independent and impartial attitude required by the Code." In re Roberts, 46 B.R. 815, 827 (Bankr. D. Utah 1985), aff'd in relevant part, 75 B.R. 402 (D. Utah 1987). In order to comply with the purpose of § 327, a Rule 2014 disclosure statement must reveal "[a]ll facts that may be relevant to a determination of whether an attorney is disinterested or holds or represents an interest adverse to the debtor's estate." In re Rusty Jones, Inc. 134 B.R. 321, 345 (Bankr. N.D. Ill. 1991) (emphasis in original) (citations omitted); distinguished on other grounds In re Grabill, 983 F.2d 773 (7th Cir. 1993) (holding that non-disinterested attorneys were not entitled to compensation for period following denial of their application to represent debtor). The disclosure requirements are broad and strictly construed. In re Leslie Fay Co., 175 B.R. 525, 533 (Bankr. S.D. N.Y. 1994). Yet Rule 2014 "does not require an attorney to dredge up every past connection, however remote, that he or she ever had with the parties in interest in the case." Rusty Jones, Inc. 134 B.R. at 346. Rather, "it is the professional's responsibility to make sure that all relevant connections are disclosed." Leslie Fay Co., 175 B.R. at 533; see also In re Begun, 162 B.R. 168, 177 (Bankr. N.D. Ill. 1993) (purpose of disclosure is to ensure that "all facts that may be relevant to the determination of professional qualification are before the [c]ourt.").

A firm's failure to disclose all relevant connections creates an independent basis for disqualifying the firm from representing the trustee. Leslie Fay Co., 175 B.R. at 533. However, courts retain a measure of discretion in determining whether non-disclosure merits a law firm's disqualification. Best Craft General Contractor & Design Cabinet, Inc. v. Wong, 239 B.R. 462, 470 (Bankr. E.D.N.Y. 1999) (citations omitted). For example, courts have held disqualification to be a particularly appropriate sanction "where counsel's undisclosed connections are material to the firm's basic qualification to represent the estate" under §327. In re Southern Kitchens, Inc., 216 B.R. 819, 830 (Bankr. D. Minn. 1998).

The requirement of the Bankruptcy Code that professionals hired by the trustee must be "disinterested" has generated much interest and debate. In the instant adversary action, Defendant objects to Trustee's retention of the Cains' attorneys as special counsel for the estate. Generally, a professional employed by the trustee cannot possess interests adverse to the estate and must be "disinterested," as defined by the Code. Premier Farms L.C., 305 B.R. at 720. However, such professionals may not be disqualified from representing the estate due to a lack of disinterest solely because they

simultaneously represent a creditor, unless there is an actual conflict of interest. 11 U.S.C. § 327(c). Yet, when a trustee retains a creditor's attorneys to represent the trustee for a limited purpose, the situation does not fit squarely within the exceptions listed under §327. See Best Craft, 239 B.R. at 467. In Best Craft, the trustee retained a law firm that had previously represented a creditor of the estate in a state court action for fraudulent inducement by the debtor's principals, the Wongs. After the debtor filed for Chapter 7 bankruptcy, the trustee retained the same law firm as special counsel in an adversary action to represent the estate in litigating possible fraudulent conveyance actions against the Wongs. In response, the Wongs filed a motion to remove the trustee's special counsel claiming the law firm's concurrent representation of the trustee and the estate's major creditor presented an actual conflict of interest.

In addressing the law firm's role as special counsel for the trustee, the Best Craft court explained that "[w]hile §327(e) contemplates employing counsel for a limited purpose, it makes reference only to a debtor's former attorney and does not mention attorneys who represent creditors." Id. Likewise, "even though §327(c) encompasses employing a creditor's attorney as counsel for the trustee, it does not explicitly provide guidance for retaining such an attorney as special counsel." Id.

To reconcile this apparent gap in the Bankruptcy Code, the Best Craft court adopted the reasoning of the Second and Ninth Circuits, which hold that retention of a creditor's law firm as special counsel is best analyzed under §327(a) and §327(c); section 327(e) is not directly, but only analogously applicable since it addresses situations where special counsel has previously represented the debtor. Id., citing In re AroChem Corp., 176 F.3d 610, 622 (2d Cir. 1999); In re Fondiller, 15 B.R. 890, 892 (B.A.P. 9th Cir. 1981). Thus "where the trustee seeks to appoint counsel only as 'special counsel' for a specific matter, there need only be no conflict between the trustee and counsel's creditor client with respect to the specific matter itself." Best Craft, 239 B.R. at 468. In other words, an attorney for the trustee that concurrently represents a creditor "must not represent an adverse interest relating to the services which are to be performed by that attorney." Id.

ANALYSIS

The Court must preliminarily determine whether Special Counsel lacks disinterest solely because of their concurrent representation of the Cains. If Special Counsel lacks disinterest due to other circumstances, the Court must disqualify them from representation of the estate.

Defendant alleges that Mr. Marcus is a creditor of the estate. Under § 101, a creditor of the estate is not a disinterested person. 11 U.S.C. § 101(14)(A). However, § 101 also stipulates that a "creditor" is a person or entity "that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." §101(10)(A). Under any interpretation of this definition, Mr. Marcus is not a creditor of Debtor's estate. Mr. Marcus does not have a claim against Debtor "that arose at the time of or before the order of relief." Id. Though he appears as a creditor on Debtor's petition, the amount owed to Mr. Marcus is listed as \$0.00. Mr. Marcus did have a contingency fee arrangement with the Cains in connection with their suit against Debtor prior to the Bankruptcy Court's order of relief. However, while such an arrangement may make Mr. Marcus a creditor of the Cains, it does not make him a creditor of the estate.

Defendant also alleges that Mr. Marcus may lack disinterest because of his past connections with two of the estate's creditors - Primus Communications and the Foss Firm. Mr. Marcus represented a client several years ago in a dispute over a \$200 bill against Primus. He also once requested a Philadelphia court to impose discovery sanctions on a defendant and law firm to which the Foss Firm acted as local counsel. These relationships are remote from the pending case and do not serve as an independent basis for disqualifying Special Counsel as competent representatives of Trustee under the Bankruptcy Code. 11 U.S.C. §101(14)(A).

Having found that the only reason for Special Counsel's lack of disinterest is concurrent representation of a creditor and Trustee, the Court must next determine whether Special Counsel represents "an adverse interest relating to the services which are to be performed" on behalf of the estate. AroChem, 176 F.3d at 622. Where "there is an identity of interest between the creditor and the estate with respect to the matter for which special counsel is retained, there is no conflict and the representation can stand." Id. (emphasis added).

Defendant asserts that Special Counsel's concurrent representation of Trustee and the Cains necessarily conflicts with the interests of the estate. However, this Court finds that there is no inherent conflict in Special Counsel's concurrent

representation. The Cains have assigned their claims against Defendant to the estate. More importantly, Trustee retained Special Counsel for the narrow purpose of litigating the adversary proceeding against Defendant. Within this adversary action, the Cains, other creditors of the estate, and Trustee all hold the "parallel interest of maximizing the estate through a recovery in the fraudulent conveyance action." Best Craft, 239 B.R. at 469.

Defendant's assertion that the Cains' claim assignment is invalid is without merit. Under Iowa law, "[n]o specific form of words is necessary to effect an assignment. Any language, however informal, if it shows the intention of the owner of the chose in action to transfer it will be sufficient to vest property in the assignee." In re Wagner, 144 B.R. 430, 437 (Bankr. N.D. Iowa 1992). Further, Defendant has failed to demonstrate that he has standing to attack the validity of the agreement between Trustee and the Cains. Defendant is not in privity with the parties to the agreement, nor has he asserted or presented any evidence that he is an intended beneficiary of the agreement. See Olney v. Hutt, 105 N.W.2d 515 (Iowa 1960). The claim assignment is an agreement between the Cains and Trustee. "One whom the law regards as a stranger to the [agreement] cannot maintain an action thereon." Id. at 519.

Finally, Defendant cites Iowa Rule of Professional Conduct 32:1.9 for the proposition that the Cains were required to give informed, written consent "prior to the transfer of their claim and the acceptance by Mr. Marcus and Mr. Courtade of employment." (Def.'s Post Tr. Brief at 7.) Rule 32:1.9 addresses duties to former clients and states in part: "a lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related manner 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." (emphasis added). Special Counsel's role in representing Trustee is to recover as much of the allegedly fraudulent conveyances as possible and return them to the estate. The Cains are the largest creditor of the estate. Defendant has failed to demonstrate that Special Counsel represents an interest which is materially adverse to the Cains, a key requirement of Rule 32:1.9.

Defendant asserts that even if Special Counsel's concurrent representation of the Cains and Trustee does not present independent grounds for disqualification, Special Counsel should be removed due to omissions in their Rule 2014 disclosure statement. Defendant argues that Special Counsel should have revealed connections with other creditors in the case, including Primus Communications and the Foss Firm. However, Special Counsel has advised the Court of the nature of these connections, and they are in no way relevant to Special Counsel's limited role in the instant adversary. The litigation in which Mr. Marcus represented a client against Primus Communications occurred several years ago and involved a dispute over \$200 in unpaid telephone bills. The discovery sanctions requested by Mr. Marcus in litigation involving the Foss Firm were against the defendant in that case and its national counsel in Philadelphia, not the Foss Firm. These undisclosed facts do not evidence any actual conflict of interest "or relationship that would color the independent and impartial attitude required by the Code." Roberts, 46 B.R. at 827.

Rule 2014 "does not require an attorney to dredge up every past connection, however remote, that he or she ever had with the parties in interest in the case." Rusty Jones, Inc. 134 B.R. at 345. Special Counsel's undisclosed connections are not "material to the firm's basic qualification to represent the estate." Southern Kitchens, Inc., 216 B.R. at 830. Disqualification is not warranted in this instance. Defendant's contention that Trustee effected improper service of the application to appoint Special Counsel is incorrect. There is no absolute requirement for either notice or hearing with respect to the employment of a professional person by a trustee. In re Crest Mirror & Door, Inc., 57 B.R. 830, 831-32 (9th Cir. 1986); Land v. First Nat'l Bank, 116 B.R. 798, 800 (D. Colo. 1990).

Finally, Trustee has requested sanctions should the Court deny Defendant's motion to remove Special Counsel. Motions to disqualify an opposing party's counsel "are frequently viewed with certain skepticism, as they can be utilized for solely tactical reasons." Best Craft, 239 B.R. at 471. Trustee asserts that Defendant's motion to remove Special Counsel lacks evidentiary support and reasonable legal contentions. (Pl.'s Post Hearing Brief at 13.) Indeed, Trustee's misgivings regarding Defendant's motivation to remove Special Counsel are not frivolous. Special Counsel have performed extensive analysis in connection with Defendant's case and are well versed on the financial trail that allegedly links Defendant to Debtor. Their willingness and ability to prosecute this case is of primary importance to the estate. Defendant's desire to have them removed from representation might cause a reasonable person to question the motives underlying this motion. Though the undisclosed facts introduced by Defendant's motion were of marginal relevance, they did demonstrate a minimal argument suggesting a conflict of interest. The Court will give Defendant the benefit of every doubt and therefore elects not to impose sanctions.

WHEREFORE, Defendant's Motion to Remove Attorneys for the Trustee is DENIED.

FURTHER, Trustee's Request for Sanctions is DENIED.

DATED AND ENTERED: December 11, 2006

Paul J. Kilburg
U.S. Bankruptcy Judge