

OCT 11 2007

NOT FOR PUBLICATION

HAROLD S. MARENUS, CLERK
U.S. BKCY. APP. PANEL
OF THE NINTH CIRCUIT

UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE NINTH CIRCUIT

In re:) BAP No. WW-06-1373-MoDJ
)
BARRY A. HAMMER,) Bk. No. 04-22244-SJS
)
Debtor.)

GLENN "RICK" GOSSER; RUTH)
GARVIN, individually and as)
Trustee of the James French)
Trust; LYNETTE OIEN; RICHARD)
OIEN; JERRY AKINS; KATHARINE)
AKINS,)
Appellants,)

AMENDED
MEMORANDUM¹

v.)
)
PETER H. ARKISON, Chapter 7)
Trustee; DEBORAH CRABBE;)
FOSTER PEPPER PLLC; BARRY A.)
HAMMER; ABLE MORTGAGE AND)
INVESTMENTS, INC.,)
Appellees.²)

Argued and Submitted on July 27, 2007
at Seattle, Washington

Original filed - August 17, 2007

Amended - October 11, 2007

Appeal from the United States Bankruptcy Court
for the Western District of Washington

¹ This disposition is not appropriate for publication. Although it may be cited for whatever persuasive value it may have (see Fed. R. App. P. 32.1), it has no precedential value. See 9th Cir. BAP Rule 8013-1.

² Only Foster Pepper PLLC has appeared on this appeal.

1 Hon. Samuel J. Steiner, Bankruptcy Judge, Presiding.

2 _____
3 Before: MONTALI, DUNN, JAROSLOVSKY,³ Bankruptcy Judges.
4

5 This is an appeal from an order granting a law firm's
6 interim fee application. The bankruptcy court reduced the law
7 firm's fees for nondisclosure of its connections with a major
8 party in interest but overruled objections that the law firm was
9 disqualified from representing the Chapter 7⁴ trustee. We
10 granted leave to appeal under 28 U.S.C. § 158(a)(3).

11 We hold that the bankruptcy court clearly erred in ruling
12 that the law firm has had no conflict of interest and has been
13 disinterested throughout this bankruptcy case. At a minimum the
14 law firm's fees must be disallowed for any periods of conflict or
15 lack of disinterestedness. The bankruptcy court must also
16 exercise its discretion to determine if it will allow any fees
17 outside of the conflicts or lack of disinterestedness, and
18 whether the law firm can represent the estate going forward. We
19 REVERSE and REMAND.
20
21

22 _____
23 ³ Hon. Alan Jaroslovsky, Bankruptcy Judge for the Northern
24 District of California, sitting by designation.

25 ⁴ Unless otherwise indicated, all chapter, section and rule
26 references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330, and
27 to the Federal Rules of Bankruptcy Procedure, Rules 1001-9036, as
28 enacted and promulgated prior to the effective date of The
Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,
Pub. L. 109-8, 119 Stat. 23 ("BAPCPA") because the case from
which this appeal arises was filed before its effective date
(generally October 17, 2005).

1 **I. FACTS**

2 Debtor Barry A. Hammer ("Debtor") is an attorney and real
3 estate developer. He filed his voluntary Chapter 7 petition on
4 September 17, 2004 (the "Petition Date"). His Chapter 7 trustee,
5 Peter H. Arkison ("Trustee"), employed Foster Pepper PLLC as his
6 attorneys ("Law Firm").

7 The City of Sultan, Washington ("City") asserts a claim
8 against Debtor for unpaid sewer assessments on his largest
9 project (the "Property"). Debtor asserts tort claims against
10 City based on its alleged damage to wetlands, inefficient
11 installation of sewers, and other misdeeds. Debtor appealed the
12 sewer assessment, filed a tort claim against City, and filed two
13 actions against City in the Snohomish County Superior Court (Case
14 Nos. 04-2-06164-9 and 04-2-06264-9, the "State Court Actions").
15 The first of these State Court Actions may no longer be pending.
16 The second seeks damages of \$12 million.

17 City is involved in this case in another important way. The
18 Property's value depends in part on whether and how City approves
19 a plat for development.

20 A. Objections to Law Firm's fees

21 In response to Law Firm's third interim fee application, a
22 group of creditors holding about \$760,000 in claims filed a
23 Supplemental Objection. Those creditors are Debtor's former
24 clients Glenn "Rick" Gosser, Ruth Garvin, individually and as
25 Trustee of the James French Trust, Lynette Oien, Richard Oien,
26 Jerry Akins, and Katharine Akins (collectively, "Creditors").

27 Creditors object that Law Firm has belatedly and
28 inadequately disclosed its connections with City, is not

1 disinterested, and has actual conflicts of interest. At a
2 preliminary hearing on Friday, July 21, 2006, the bankruptcy
3 court denied Creditors' request for a 60 to 90 day continuance
4 for discovery and set an evidentiary hearing for Wednesday, July
5 26, 2006.

6 At oral argument before us, Creditors' counsel clarified
7 that they are not seeking disgorgement of all of Law Firm's fees
8 in this case. Instead they believe that Law Firm cannot continue
9 to represent Trustee as general counsel going forward; they seek
10 disallowance of any fees incurred on specific matters involving
11 conflicts or lack of disinterestedness; they also seek
12 disallowance of fees for handling general case matters that the
13 Law Firm would not have performed had it made proper disclosures
14 at the outset, and thus would not have been employed; and they
15 ask that Law Firm's fees be further reduced to cover the expense
16 of retaining new counsel who will have to get up to speed on the
17 case.

18 The following matters are at issue in this appeal.

19 B. Law Firm's pre- and post-petition work for City, and
20 belated disclosures

21 Law Firm represented City pre-petition in connection with
22 City's issuance of approximately \$3.6 million in bonds secured by
23 sewer assessments on the Property and other real estate. This
24 project is known as Sewer Improvement Assessment, Local
25 Improvement District ("LID") 97-1. Law Firm prepared a
26 disclosure of Debtor's claims for prospective purchasers of the
27 LID 97-1 bonds. Law Firm stated that those claims "do not appear
28 to question the validity or enforceability of [the] assessments"

1 (which Creditors dispute) and that the statutory period "for
2 filing notices of appeal to the Superior Court from [the]
3 assessments" has expired without any such notice having been
4 filed (which appears to be undisputed). Law Firm's work on the
5 LID 97-1 bonds was not completed until just before the Petition
6 Date, although Law Firm maintains that the work was substantially
7 complete in February of 2003.

8 As of the Petition Date this bond work for City was unknown
9 to Law Firm's principal attorney on this case, Deborah Crabbe
10 ("Ms. Crabbe"). Her declaration in support of Law Firm's
11 employment states:

12 To the best of my knowledge, neither I nor
13 any other person in my office has any connection
14 with Debtor, the Debtor's creditors, or any other
15 party in interest, or their respective attorneys
16 and accountants. * * * I believe [Law Firm] is a
"distinterested person["] for the purposes of
§ 101(14) and § 327 of the United States
Bankruptcy Code.

17 Law Firm concedes that it should have discovered and
18 disclosed its pre-existing connections with City. City is one of
19 only nine creditors on the initial creditor matrix, the claims by
20 and against City are listed on Debtor's bankruptcy schedules and
21 statement of financial affairs, and City filed a request for
22 special notice and a proof of claim. Ms. Crabbe later declared,
23 "I believe that I mistakenly failed to run a thorough conflict
24 check when I opened the Hammer matter." She also explained that
25 Law Firm, which has about 100 lawyers, is large enough that she
26 was unaware that her partner, Mr. Lee Voorhees, was City's bond
27 counsel.

28 Ms. Crabbe became aware of these facts in February of 2005

1 when another of her partners was meeting with Debtor to discuss
2 his pre-petition claims against third parties. Law Firm
3 immediately determined not to discuss any claims against City
4 with Debtor or review any documents related to those claims. Law
5 Firm notified Trustee and the Office of the United States Trustee
6 ("UST") but did not file anything to disclose this issue on the
7 record or notify the bankruptcy court.

8 Debtor and his counsel discussed the potential conflict with
9 Law Firm again in June of 2005. Again Law Firm did not notify
10 the bankruptcy court or creditors.

11 On November 18, 2005, Debtor's new counsel raised the issue
12 a third time with Ms. Crabbe. She then filed a declaration,
13 dated November 21, 2005, disclosing that Law Firm had represented
14 City. She did not state that the LID 97-1 matter involved both
15 Debtor and the Property, nor that Law Firm was named in Debtor's
16 revised tort claim as a "person involved," nor that Law Firm had
17 evaluated Debtor's claims and aided City in responding to
18 Debtor's public records requests. Law Firm alleges that its
19 evaluation of the claims for City was solely for purposes of
20 disclosure to bond purchasers. Creditors believe that Law Firm
21 may have advised City more broadly about the claims.

22 Ms. Crabbe declared that on the day when she learned about
23 Law Firm's bond work for City she was leaving on a sixteen day
24 vacation and "[w]hile I was gone, I completely forgot about the
25 issue and did nothing about the matter on my return." She
26 admitted that "[i]n hindsight I should have filed this
27 supplemental declaration in February 2005" and also stated that
28 Law Firm was "examining its conflict check input process to

1 determine how this problem can be avoided in the future.”

2 At a hearing on November 23, 2005, Ms. Crabbe told the
3 bankruptcy court that Law Firm had not done any work for City
4 since the Petition Date. This was incorrect. Law Firm worked on
5 at least one matter for City post-petition, and had four open
6 files for City as of the Petition Date including a general file,
7 an “Assistant City Attorney” file, and files relating to
8 construction of an emergency radio tower and a special levy. Law
9 Firm billed City a total of approximately \$5000 in 2004 and 2005.
10 Creditors state that because the bankruptcy court denied them an
11 adequate opportunity for discovery, they cannot concede that Law
12 Firm’s post-petition work is unrelated to estate business.

13 Law Firm billed another 0.6 of an hour to City in April of
14 2006. On July 20, 2006, Ms. Crabbe disclosed this billing and
15 the other post-petition work described above. She stated that
16 the “only explanation for this occurrence was a failure of the
17 firm’s conflicts management system.” She also disclosed for the
18 first time that Law Firm is City’s primary bond counsel. At the
19 evidentiary hearing on July 26, 2006, it was revealed that Law
20 Firm has billed City approximately \$180,000 between 2000 and
21 2005.

22 C. City’s claim against the estate

23 Law Firm filed an omnibus objection to 108 claims, which
24 proposed to allow City’s claim in full as a secured claim to be
25 paid from proceeds upon sale of the Property. City wrote to Law
26 Firm requesting clarification that post-petition interest would
27 be allowed and Ms. Crabbe’s daily time records reflect a
28 telephone conversation with the author of that letter about the

1 claim. Law Firm then submitted and the bankruptcy court signed
2 an order allowing City's claim "as a secured claim in the sum of
3 \$644,942.31 plus any accrued and accruing interest and penalties
4 to be paid from the proceeds of the sale of the [Property]."
5 (Emphasis added.) Creditors object to the emphasized language,
6 which did not appear in Law Firm's original proposed order.

7 D. The estate's claims against City

8 In February of 2005 Law Firm and Trustee determined that the
9 estate's claims against City should be forwarded to special
10 counsel for review. Law Firm forwarded documents to Inslee Best
11 Doezie & Ryder, P.S. but no order ever authorized employment of
12 this firm and it is not clear exactly what advice it gave to
13 Trustee. Law Firm alleges that this firm gave a negative
14 assessment of Debtor's claims.

15 Trustee and Law Firm do not appear to have done anything
16 further -- except for filing a notice of bankruptcy in one of the
17 State Court Actions -- until August of 2006 when Trustee applied
18 for authority to expand the employment of special counsel to
19 evaluate the State Court Action. Creditors argue that this left
20 special counsel with too little time because the two year
21 extension provided by Section 108(a) expired less than one month
22 later, on September 17, 2006, and not acting by that deadline
23 would allegedly bar some claims that the estate may have against
24 City.

1 E. The plat approval process

2 Creditors object to Law Firm's involvement in seeking plat
3 approval from City. Law Firm responds that it is not involved in
4 that process, and that Trustee is instead represented before
5 City's hearing examiner by an engineering and surveying company,
6 Group Four, Inc. ("Group Four").

7 F. The bankruptcy court's rulings

8 After the evidentiary hearing on July 26, 2006, the
9 bankruptcy court took the matter under advisement. On August 14,
10 2006, it issued its oral ruling that there has been no conflict
11 of interest, Law Firm is disinterested, the failure to disclose
12 Law Firm's relationship with City was the result of mistake or
13 oversight which "has not prejudiced the estate" or "anyone,"
14 there is no appearance of impropriety, and "the legal work
15 performed in this complex and difficult case has been, in my
16 opinion, outstanding," and "it is difficult for me to imagine the
17 time and cost to the estate that would be involved in bringing
18 new counsel up to snuff." Transcript, August 14, 2006, pp. 9:25-
19 11:7. Nevertheless, as a penalty for Law Firm's "failure to
20 disclose" the bankruptcy court held that in its discretion it
21 would deduct \$20,000 from the amount requested and disapprove any
22 compensation for preparing or defending the fee application. Id.
23 pp. 11:8-20.

24 On October 11, 2006, the bankruptcy court entered an order
25 incorporating its oral ruling and awarding Law Firm interim fees
26 of \$133,104.50 and costs of \$6,793.33. Creditors filed a notice
27 of appeal. Our clerk issued an order questioning the finality of
28 the order on appeal and Creditors filed a motion for leave to

1 appeal, which our motions panel granted over Law Firm's
2 opposition.⁵

3 II. ISSUE

4 Did the bankruptcy court err in determining that Law Firm
5 has had no conflict of interest, is disinterested, is not
6 disqualified from being compensated, and should not have its fees
7 further reduced?

8 III. STANDARDS OF REVIEW

9 Orders on employment, disqualification, and compensation of
10 professionals are all reviewed for abuse of discretion. Movitz
11 v. Baker (In re Triple Star Welding, Inc.), 324 B.R. 778, 788
12 (9th Cir. BAP 2005); COM-1 Info, Inc. v. Wolkowitz (In re Maximus
13 Computers, Inc.), 278 B.R. 189, 194 (9th Cir. BAP 2002). Whether
14 a professional is disinterested or a conflict of interest exists
15 is also reviewed for abuse of discretion. Magten Asset Mgmt.
16 Corp. v. Paul Hastings et al. (In re Northwestern Corp.), 346
17 B.R. 84, 87 (D. Del. 2006) (citing In re BH&P Inc., 949 F.2d 1300
18 (3d Cir. 1991)).

19 A bankruptcy court necessarily abuses its discretion if it
20 bases its ruling upon an erroneous view of the law. Triple Star,
21 324 B.R. at 788. Legal issues, including statutory
22

23 ⁵ We are not bound by the decision of the motions panel but
24 we agree that leave to appeal was properly granted in this case.
25 See 28 U.S.C. § 158(a)(3), and, e.g., Travers v. Dragul (In re
26 Travers), 202 B.R. 624, 626 (9th Cir. BAP 1996) ("Granting leave
27 is appropriate if the order involves a controlling question of
28 law where there is substantial ground for difference of opinion
and when the appeal is in the interest of judicial economy
because an immediate appeal may materially advance the ultimate
termination of the litigation.") (citation omitted).

1 interpretation, are reviewed de novo. Id.

2 We also find an abuse of discretion if we have a definite
3 and firm conviction that the bankruptcy court committed a clear
4 error of judgment in the conclusion it reached. Triple Star, 324
5 B.R. at 788. We review factual findings for clear error. Id.

6 **IV. DISCUSSION**

7 The bankruptcy court clearly erred in finding that there was
8 no conflict of interest and that Law Firm was disinterested at
9 all times. At the very least, Law Firm's review of City's claim
10 and its involvement in the platting process presented actual
11 conflicts of interest, or a lack of disinterestedness, or both.
12 Also, it appears that even now Law Firm might not have been fully
13 candid in its disclosures. We explore these issues, and the
14 appropriate remedies, below.

15 A. Legal standards

16 Attorneys for the bankruptcy estate are held to a high
17 standard. Under Section 327(a) they may not "hold or represent
18 an interest adverse to the estate," and under Section 327(c),
19 although they are not disqualified "solely" because of employment
20 by or representation of a creditor, the bankruptcy court "shall"
21 disapprove their employment upon objection if there is an "actual
22 conflict of interest." 11 U.S.C. § 327(a) and (c) (emphasis
23 added).⁶

24
25 ⁶ Section 327(a) and (c) state, in full:

26 (a) Except as otherwise provided in this
27 section, the trustee, with the court's approval,
28 may employ one or more attorneys, accountants,
appraisers, auctioneers, or other professional

1 In differentiating subsections (a) and (c) of Section 327,
2 the courts sometimes distinguish so-called "potential" conflicts
3 from the "actual conflicts" mentioned in the statute:

4 Section 327(a), as well as § 327(c), imposes a per
5 se disqualification as trustee's counsel of any
6 attorney who has an actual conflict of interest
7 [whereas] the [bankruptcy] court may within its
8 discretion -- pursuant to § 327(a) and consistent
9 with § 327(c) -- disqualify an attorney who has a
10 potential conflict of interest

11 Dye v. Brown (In re AFI Holding, Inc.), 355 B.R. 139, 154 (9th
12 Cir. BAP 2006) (quoting In re Marvel Entm't Group, 140 F.3d 463,
13 476 (3d Cir. 1998)) (emphasis added).

14 Section 327(a) also requires the professional to be a
15 "disinterested person," defined in Section 101(14) to mean a
16 person who, among other things, "does not have an interest
17 materially adverse to the interest of the estate or of any class
18 of creditors or equity security holders, by reason of any direct
19 or indirect relationship to, connection with, or interest in, the

20 persons, that do not hold or represent an interest
21 adverse to the estate, and that are disinterested
22 persons, to represent or assist the trustee in
23 carrying out the trustee's duties under this
24 title.

25 * * *

26 (c) In a case under chapter 7, 12, or 11 of
27 this title, a person is not disqualified for
28 employment under this section solely because of
such person's employment by or representation of a
creditor, unless there is 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(a) and (c) (emphasis added).

1 debtor . . . or for any other reason[.]” 11 U.S.C. § 101(14)(E)
2 (emphasis added).

3 The terms “materially adverse” (Section 101(14)(E)) and
4 “interest adverse to the estate” (Section 327(a)) are not
5 defined, but

6 A generally accepted definition of “adverse
7 interest” is the (1) possession or assertion of an
8 economic interest that would tend to lessen the
9 value of the bankruptcy estate; or (2) possession
10 or assertion of an economic interest that would
11 create either an actual or potential dispute in
12 which the estate is a rival claimant; or (3)
13 possession of a predisposition under circumstances
14 that creates a bias against the estate.

15 AFI Holding, 355 B.R. at 148-49. See also Tevis v. Wilke, Fleury
16 et al. (In re Tevis), 347 B.R. 679, 688 (9th Cir. BAP 2006)
17 (similar definition).

18 The reported cases are not entirely consistent in their
19 terminology. There is some criticism of the term “potential
20 conflict.” AFI Holding, 355 B.R. at 146 n. 5. There is also
21 some disagreement whether the appearance of a conflict is
22 sufficient by itself for disqualification. Compare Marvel, 140
23 F.3d at 476 (appearance alone is not sufficient) with In re
24 Martin, 817 F.2d 175, 180-81 (1st Cir. 1987) (implying the
25 opposite). Cf. AFI Holding, 355 B.R. at 153-54 (noting but not
26 deciding issue). We have held that avoiding the appearance of
27 impropriety is already one of the goals incorporated into the
28 statutes and rules (see id. at 153), and we agree with another
court that,

29 The debate over this issue may be more
30 semantic than substantive, for a close review of
31 the [reported] cases indicates that the results
32 were largely driven by the facts of each case.
33 And indeed, in the context of section 327, that is

1 precisely the way it should be. Potential
2 conflicts, no less than actual ones, can provide
3 motives for attorneys to act in ways contrary to
4 the best interests of their clients. Rather than
5 worry about the potential/actual dichotomy it is
6 more productive to ask whether a professional has
7 either a meaningful incentive to act contrary to
8 the best interests of the estate and its sundry
9 creditors -- an incentive sufficient to place
10 those parties at more than acceptable risk -- or
11 the reasonable perception of one. In other words,
12 if it is plausible that the representation of
13 another interest may cause the debtor's attorneys
14 to act any differently than they would without
15 that other representation, then they have a
16 conflict and an interest adverse to the estate.

17 In re Leslie Fay Co's, Inc., 175 B.R. 525, 533 (Bankr. S.D.N.Y.
18 1994) (emphasis added, citations and internal quotation marks
19 omitted). See also AFI Holding, 355 B.R. at 149 (quoting
20 authority that 11 U.S.C. § 101(14) (E) covers any interest or
21 relationship that "would even faintly color the independence and
22 impartial attitude required by the [Bankruptcy] Code") (citations
23 omitted); In re Quality Beverage Co., Inc., 216 B.R. 592, 595
24 (Bankr. S.D. Tex. 1995).

25 The bankruptcy court does not have authority to allow
26 employment of a professional in violation of Section 327 or
27 Section 101(14). Mehdipour v. Marcus & Millichap (In re
28 Mehdipour), 202 B.R. 474, 478 (9th Cir. BAP 1996); First
Interstate Bank of Nev., N.A. v. CIC Inv. Corp. (In re CIC Inv.
Corp.), 175 B.R. 52, 56 (9th Cir. BAP 1994).

Valid employment is generally a prerequisite to
compensation,⁷ although employment can sometimes be approved

⁷ Section 330(a) provides, in part, that the bankruptcy
court "may award to . . . a professional person employed under
section 327 or 1103 -- (A) reasonable compensation for actual,
necessary services . . . and (B) reimbursement for actual,

1 retroactively. Mehdipour, 202 B.R. at 479. There is no quantum
2 merit compensation under Section 503, although the bankruptcy
3 court "has discretion to award or deny compensation for services
4 outside of a conflict." Id. at 478-79 (emphasis added)
5 (citations omitted). See also 11 U.S.C. § 328(c).

6 The above statutory provisions work in tandem with Rule
7 2014, which states that a professional's application for
8 employment "shall be accompanied by a verified statement of the
9 person to be employed setting forth the person's connections with
10 the debtor, creditors, any other party in interest, their
11 respective attorneys and accountants, the [UST], or any person
12 employed in the office of the [UST]." Fed. R. Bankr. P. 2014.
13 This has been interpreted to impose an ongoing duty of
14 disclosure. In re West Delta Oil Co., Inc., 432 F.3d 347, 355
15 (5th Cir. 2005). The penalty for nondisclosure is within the
16 bankruptcy court's discretion, and can range from nothing (CIC
17 Inv. Corp., 175 B.R. at 54) to disallowance of all fees. Neben &
18 Starrett, Inc. v. Chartwell Fin. Corp. (In re Park-Helena Corp.),
19 63 F.3d 877, 882 (9th Cir. 1995).

20 State and national rules of professional responsibility also
21 apply, provided that they do not conflict with the Bankruptcy
22 Code and Rules. See generally AFI Holding, 355 B.R. at 153
23 n. 15. Washington State's Rules of Professional Conduct ("RPC")
24 prohibit lawyers from representing current clients with
25

26
27
28 necessary expenses." 11 U.S.C. § 330(a)(1).

1 conflicting interests⁸ and limit lawyers' ability to take on any
2 representation materially adverse to former clients.⁹ Conflicts
3 can also be imputed from one attorney to another within a law
4 firm.¹⁰

6 ⁸ Rule 1.7 Conflict of Interest: Current Clients

7 (a) Except as provided in paragraph (b) [clients'
8 informed written consent], a lawyer shall not
9 represent a client if the representation involves
10 a concurrent conflict of interest. A concurrent
11 conflict of interest exists if:

12 (1) the representation of one client will be
13 directly adverse to another client; or

14 (2) there is a significant risk that the
15 representation of one or more clients will be
16 materially limited by the lawyer's
17 responsibilities to another client, a former
18 client or a third person or by a personal
19 interest of the lawyer. [Emphasis added.]

20 Rule 1.7(a), Wash. Rules of Prof. Conduct.

21 ⁹ Rule 1.9 Duties to Former Clients

22 (a) A lawyer who has formerly represented a client
23 in a matter shall not thereafter represent another
24 person in the same or a substantially related
25 matter in which that person's interests are
26 materially adverse to the interests of the former
27 client unless the former client gives informed
28 consent, confirmed in writing. [Emphasis added.]

29 Rule 1.9(a), Wash. Rules of Prof. Conduct.

30 ¹⁰ Washington State's rule on imputation may be less
31 stringent than other state rules or national model rules:

32 Rule 1.10 Imputation of Conflicts of Interest:
33 General Rule

34 (a) Except as provided in paragraph (e) [pre-

1 B. Handling of City's claim against the estate

2 Law Firm reviewed City's claim for Trustee at the same time
3 as it was representing City. That is impermissible. See
4 generally Fondiller v. Robinson (In re Fondiller), 15 B.R. 890,
5 892 (9th Cir. BAP 1981) (noting that reviewing claims "to
6 determine which should be disputed" is "adverse" to the creditors
7 holding such claims), appeal dismiss., 707 F.2d 441 (9th Cir. 1983).
8 See also Tevis, 347 B.R. at 691 (law firm could not have
9 simultaneously represented clients with adverse interests, even
10 on unrelated matters).

11 Law Firm characterizes its post-petition work for City as
12 one or two isolated matters but, as Creditors argue convincingly,
13 there is substantial evidence that City is an "institutional
14 client" that consults Law Firm on an "on-call basis."
15 Transcript, July 26, 2006, p.m. Session, p. 86:11. Any contrary
16 conclusion is not supported by the excerpts of record.

17 The fact that Law Firm was handling only small matters for
18

19 existing ethical screen], while lawyers are
20 associated in a firm, none of them shall knowingly
21 represent a client when any one of them practicing
22 alone would be prohibited from doing so by Rules
23 1.7 or 1.9, unless the prohibition is based on a
24 personal interest of the prohibited lawyer and
25 does not present a significant risk of materially
26 limiting the representation of the client by the
27 remaining lawyers in the firm.

28 Rule 1.10(a), Wash. R. Prof. Conduct.

26 We express no opinion whether the Bankruptcy Code and Rules
27 incorporate more stringent rules regarding imputation of
28 conflicts. The parties have not addressed this issue and it can
be addressed by the bankruptcy court on remand, to the extent
that may be necessary or appropriate.

1 City at this particular time is irrelevant. In a comparable case
2 the bankruptcy court responded, the "short answer to this is that
3 [the law firm] should be presumed to be loyal to its client" no
4 matter how "relatively insignificant" that client is. Leslie
5 Fay, 175 B.R. at 535.¹¹

6 Alternatively, even it were possible to say that Law Firm
7 did not "represent" City within the meaning of Section 327(a) at
8 the precise time when it was reviewing City's claim, Law Firm
9 still "hold[s]" or "ha[s]" interests that are materially adverse
10 to the estate. 11 U.S.C. §§ 101(14)(E) and 327(a). First, Law
11 Firm has an incentive not to jeopardize its future relationship
12 with a client who has paid it approximately \$180,000 in recent
13 years.

14 Second, Law Firm has not adequately rebutted Creditors'
15 objection that it could be exposed to liability if City's claim
16 for assessments is defective. Law Firm argues that it did not
17

18 ¹¹ Law Firm argues in a footnote in its brief on appeal
19 that even if Mr. Voorhees is not disinterested that does not
20 disqualify the entire firm, citing U.S. Trustee v. S.S. Retail
21 Stores Corp. (In re S.S. Retail Stores Corp.), 211 B.R. 699, 703
(9th Cir. BAP 1997), app. disp., 162 F.3d 1230 (9th Cir. 1998).
That case is inapposite.

22 Mr. Voorhees has represented City at the same time as Law
23 Firm was representing Trustee in reviewing and allowing City's
24 claim. His duty of loyalty to City and any knowledge he might
25 have regarding weaknesses or strengths of City's claim are
26 imputed to Law Firm. This is very different from S.S. Retail, in
27 which an attorney at a law firm was an assistant secretary on the
28 debtor's board of directors and was not alleged to know anything
"contrary to the debtor's interests." Id. at 702 (quoting
bankruptcy court). We held that the individual attorney's status
as a corporate officer was not imputed to the rest of his law
firm, and we specifically distinguished the imputation of
knowledge. Id. at 702-03.

1 actually handle the assessment work for City (although Creditors
2 seek discovery on that issue). Even if that is so, it is
3 insufficient. Law Firm was bond counsel on the LID 97-1 bonds
4 and as such it rendered an opinion that the bonds secured by the
5 assessments are enforceable. Law Firm therefore has an incentive
6 not to expose any defect in the assessments. Whether or not Law
7 Firm would actually be influenced by that incentive, it is
8 disqualified from reviewing City's claim. See In re Leslie Fay
9 Co's, Inc., 175 B.R. at 535-36 ("when evaluating conflicts of
10 interest, I must do so objectively, 'irrespective of the
11 integrity of the person under consideration.'") (citation
12 omitted). See also AFI Holding, 355 B.R. at 155.

13 Law Firm argues that there is no evidence of any actual harm
14 to the estate, but that argument has several flaws. First,
15 "[h]arm to the estate is not necessary to a decision to order
16 disgorgement of fees where there is a conflict of interest." In
17 re eToys, Inc., 331 B.R. 176, 193 (Bankr. D. Del. 2005). Second,
18 Creditors were not allowed time for discovery, and discovery
19 might reveal actual harm. Third, the excerpts of record already
20 do appear to show actual harm in the treatment of City's claim
21 for penalties.

22 Creditors' Supplemental Objection complains that Law Firm
23 changed its proposed order to add the phrase "plus any accrued
24 and accruing interest and penalties" to City's allowed claim.
25 (Emphasis added.) Ms. Crabbe testified that City's claim "has to
26 include interest" because "it's an oversecured claim."
27 Transcript, July 26, 2006, p.m. Session, p. 23:3-20. See 11
28 U.S.C. § 506(b). That may be so, but Law Firm offers no

1 justification for allowing pre- and post-petition penalties. See
2 11 U.S.C. § 724(a) (avoidance of liens for tax penalties); Norton
3 Bankr. L. & Pract. 2d § 71:2 (same); In re Brentwood Outpatient,
4 Ltd., 43 F.3d 256, 259-65 & n. 5 (6th Cir. 1994) (post-petition
5 tax penalties are not secured under 11 U.S.C. § 506(b) because
6 they arise by operation of law rather than by "agreement"¹²); In
7 re Boardwalk Partners, 171 B.R. 87, 93 (Bankr. D. Ariz. 1994)
8 (penalties disallowed based on "reasonableness" inquiry under 11
9 U.S.C. § 506(b)); Norton Bankr. L. & Pract. 2d § 43:3 at nn. 9-12
10 (tax penalties generally).

11 Instead of raising any objection to City's penalties, Law
12 Firm proposed to allow its claim in full, including \$7,731.33 in
13 pre- and post-petition penalties. Then, in response to City's
14 letter asking for accruing post-petition interest, Law Firm
15 revised its proposed order to include both that interest and
16 accruing penalties. This may be an innocent oversight, or Law
17 Firm might have good reasons for allowing City's penalty claims,
18 but Law Firm submitted its revised order with no notice or
19 explanation of the change in wording. We cannot presume that
20 there was no harm.

21 For all of these reasons, Law Firm was not disinterested and
22 had an actual conflict of interest when it handled City's claim.
23 We address the possible remedies at the end of this discussion.

24 C. Handling of the estate's claims against City

25 Trustee hired special counsel to evaluate the estate's
26

27 ¹² Section 506(b) was amended by BAPCPA to add the words
28 "or State statute" after "agreement," but BAPCPA is inapplicable
to this case (see footnote 4 above).

1 claims against City. Special counsel consulted two land use
2 attorneys, conducted its own research, and concluded that the
3 State Court Action would be "very expensive [to litigate] with a
4 very low probability of the [T]rustee prevailing." Creditors
5 object that Law Firm could have subtly influenced Trustee and
6 that special counsel did not have adequate time to evaluate the
7 claims. This is speculation. There is no evidence in the
8 excerpts of record of any influence exerted by Law Firm nor that
9 special counsel complained that it had insufficient time.

10 Creditors also object that Law Firm filed a notice of
11 bankruptcy in one of the State Court Actions. We assume without
12 deciding that by filing the notice Law Firm preserved a \$12
13 million action that otherwise would have been dismissed. The
14 trouble for Creditors is that if anything this benefitted the
15 bankruptcy estate. There was still an actual conflict of
16 interest -- Law Firm should not have had any involvement in an
17 action by one client against another -- but because the estate
18 was arguably benefitted and the involvement was minimal we
19 believe that the bankruptcy court had discretion not to
20 disqualify Law Firm or disallow more fees than it did. See
21 Mehdipour, 202 B.R. at 478.

22 D. Handling of plat approval process with City

23 Creditors' expert on land use law testified that the plat
24 approval process is inherently adverse to City because "the city
25 is charged with enforcing its land use codes and getting a good
26 deal for the public, and the developer is trying to get the best
27 subdivision they can." Transcript, July 26, 2006, p.m. Session,
28 pp. 49:22-51:16, 53:10-13. Law Firm attempts to suggest

1 otherwise, but the bankruptcy court made no findings that would
2 support this and it appears to us that the plat approval process
3 is inherently adversarial.

4 By way of analogy, buyers and sellers sometimes have
5 friendly negotiations and are both pleased with the outcome, but
6 for purposes of analyzing conflicts of interest and
7 disinterestedness their relationship is inherently adversarial.
8 See generally In re Perry, 194 B.R. 875 (E.D. Cal. 1996) (law
9 firm's dual representation of trustee and general partner of
10 entity seeking to purchase estate assets constituted an
11 impermissible conflict of interest).

12 Therefore Law Firm cannot represent Trustee in the plat
13 approval process. Law Firm argues that it is not actually
14 representing Trustee in this process, and instead the engineering
15 and surveying company Group Four is representing Trustee before
16 City's hearing commissioner. Ms. Crabbe testified that "Group
17 Four is handling it all" and "[w]e've had two meetings with them
18 just to have them tell us what was going on in the case."
19 Transcript, July 26, 2006, pp. 80:18, 85:2-4.

20 We are not persuaded. As Creditors point out, Law Firm's
21 time records contain about a dozen entries involving the plat
22 approval process. Some meetings lasted several hours, they
23 occurred during the time when Law Firm was reminded again about
24 its other connections with City, and one plat approval meeting of
25 over 3 hours was with City itself:

26 11/9/05 Attend meeting with G4 regarding status
27 of preliminary plat process (4.6
[hours])

28 11/21/05 Telephone conversation with M [Mark H.]

1 Weber [Regional Assistant U.S. Trustee]
2 regarding Sultan conflict issue (0.2);
3 draft supplemental declaration
4 discussing Sultan conflict issue (0.4);
5 telephone conversation with P. Arkison
6 regarding status of plat and meeting
7 with Group Four (0.2)

8 12/20/05 Attend meeting with G4 and city of
9 Sultan regarding preliminary plat (3.2)
10 [Emphasis added.]

11 Law Firm's second and third interim fee applications also
12 flatly state that Law Firm "worked with" other professionals to
13 prepare and file a preliminary plat. The third interim
14 application and Ms. Crabbe's supporting declaration both go
15 further and state that Law Firm worked with City as well:

16 [Law Firm] continued to work with Group 4 and the
17 city of Sultan regarding the preliminary plat
18 process for the [Property]. [Emphasis added.]

19 In sum, the excerpts of record contradict Law Firm's
20 contention that it was not actually working on the plat approval
21 process. Even now Law Firm has not been fully candid about its
22 involvement, as it is required to be. See Tevis, 347 B.R. at
23 694. Again, we address possible remedies at the end of this
24 discussion.¹³

25 ¹³ Creditors' attorney argued before the bankruptcy court
26 that Law Firm's connections to City are important not just
27 because of disinterestedness and conflicts of interest but also
28 because they could cause costly delays and jeopardize the
development:

. . . if citizens of [City] who oppose development
-- and there are a lot of them . . . find out that
the Hammer estate, who is trying to develop a 72-
acre parcel, is also represented by attorneys who
represent the [City], I can only imagine the due
process claims and the damage that will be caused.

1 E. Nondisclosure

2 Law Firm's nondisclosure would warrant sanctions even if it
3 is not otherwise disqualified from employment or compensation.
4 Kravit, Gass & Weber, S.C. v. Michel (In re Crivello), 134 F.3d
5 831, 836 (7th Cir. 1998) ("Though [Rule 2014] allows the fox to
6 guard the proverbial hen house, counsel who fail to disclose
7 timely and completely their connections proceed at their own risk
8 because failure to disclose is sufficient grounds to revoke an
9 employment order and deny compensation.").

10 Law Firm repeatedly failed to identify a basic conflict of
11 interest, its disclosures were sloppy and incomplete, and its
12 attitude to disclosure was cavalier and misleading. That is
13 unacceptable.

14 In mitigation, the bankruptcy court found that the
15 nondisclosures were the result of mistake or oversight.
16 Creditors do not challenge that finding. At the evidentiary
17 hearing an attorney for one of the estate's largest creditors
18 appeared and suggested that this nondisclosure "could happen to
19 any of us" and "I think a fair thing for the Court to do would be
20 to say the amount that [Law Firm] billed to [City] is coming off
21 the top of your bill, end of story." Transcript, July 26, 2006,
22
23

24 _____
25 And the delay to the estate could be huge.

26 Transcript, July 26, 2006, p.m. Session, p. 88:11-20.

27 The bankruptcy court made no findings or analysis with
28 respect to this issue and therefore we express no opinion on it.
It can be addressed as appropriate on remand.

1 a.m. Session, pp. 70:6-71:1.¹⁴ The UST later agreed and
2 recommended reducing Law Firm's fees by \$5000, or else some
3 unspecified percentage, "as a sanction for the lack of disclosure
4 in this case." Transcript, July 26, 2006, p.m. Session,
5 pp. 62:16-63:25. Instead the bankruptcy court reduced Law Firm's
6 fees by \$20,000.

7 Ordinarily we might defer to the bankruptcy court's exercise
8 of its discretion in this matter (CIC Inv. Corp., 175 B.R. at
9 54), but in this case the bankruptcy court did not recognize the
10 extent of Law Firm's nondisclosures. The bankruptcy court was
11 misled into believing that Law Firm had no actual conflicts of
12 interest, whereas we have determined that Law Firm had conflicts
13 and a lack of disinterestedness both in reviewing City's claim
14 and in working on the plat approval process. On remand the
15 bankruptcy court can consider what discovery might be appropriate
16 and, once the facts are fully known, whether additional sanctions
17 are appropriate for Law Firm's nondisclosures.

18 F. Remedies

19 On remand the bankruptcy court must at the very least
20 disallow Law Firm's fees for its work relating to City's claim
21 and the platting process. It must also exercise its discretion
22

23 ¹⁴ He also stated, "if you really wanted to make the point,
24 I'd say . . . wait to get paid for this fee application until
25 there's a distribution to creditors." Transcript, July 26, 2006,
26 a.m. Session, p. 71:1-3. The bankruptcy court did that, ordering
27 Trustee to defer payment of all but \$35,000 in fees "until
28 there's substantially more in this estate," not as a sanction but
because creditors had received "only a minimal dividend" while
"substantial sums have been paid out in attorney's fees."
Transcript, August 14, 2006, pp. 11:21-12:12.

1 to determine whether to allow any of Law Firm's fees for work
2 outside of this conflict and lack of disinterestedness, and
3 whether Law Firm is disqualified from representing Trustee going
4 forward, as either general or special counsel. See generally
5 Hunter Sav. Ass'n v. Baggott Law Offices Co. (In re Georgetown of
6 Kettering, Ltd.), 750 F.2d 536, 540-41 (6th Cir. 1984) (denial of
7 all fees for actual conflict of interest); Gray v. English, 30
8 F.3d 1319, 1323-25 (10th Cir. 1994) (post-petition lack of
9 disinterestedness disqualified law firm, and bankruptcy court
10 should "lean strongly toward denial of fees," but where services
11 were "extraordinary" and estate was not harmed, it was not abuse
12 of discretion to allow fees incurred prior to lack of
13 disinterestedness); Leslie Fay, 175 B.R. 525 (law firm required
14 to pay \$800,000 to examiner, plus fees and costs incurred by
15 other parties in investigating its conflicts, and new counsel
16 would be required for any new matters, but where creditors'
17 committee did not favor disqualification and reorganization was
18 at critical stage, law firm could continue representing estate on
19 existing matters).

20 **V. CONCLUSION**

21 Law Firm cannot represent one client against another. Even
22 if City was not Law Firm's client at all relevant times, Law Firm
23 has incentives not to jeopardize its valuable relationship with
24 City or expose itself to possible liability by exposing any
25 weakness in City's claim for assessments. Therefore Law Firm was
26 disqualified from reviewing City's claim, let alone recommending
27 allowance of that claim in full with pre- and post-petition
28 penalties. Law Firm also improperly involved itself in the plat

1 approval process with City, despite its protestations that this
2 is all being handled by the Group Four engineers and surveyors.
3 The bankruptcy court clearly erred in finding that Law Firm had
4 no conflict of interest and was at all times disinterested.

5 On remand the bankruptcy court must at a minimum disallow
6 Law Firm's fees during the time of any actual conflict of
7 interest or lack of disinterestedness. The bankruptcy court must
8 also exercise its discretion to determine whether to allow Law
9 Firm's fees for any other period; or for any isolated tasks
10 unrelated to the conflict and lack of disinterestedness; or for
11 fees that relate to general case administration that would not
12 have been earned had the Law Firm never been employed; and
13 whether Law Firm may represent Trustee as general or special
14 counsel going forward. The bankruptcy court's order allowing Law
15 Firm's fees on an interim basis is REVERSED and this matter is
16 REMANDED.