

AUG 17 2007

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

NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY APPELLATE PANEL  
OF THE NINTH CIRCUIT

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

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

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

MEMORANDUM<sup>1</sup>

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

Filed - August 17, 2007

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

Honorable Samuel J. Steiner, Bankruptcy Judge, Presiding

<sup>1</sup> 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.

<sup>2</sup> Only Foster Pepper PLLC has appeared on this appeal.

1 Before: MONTALI, DUNN and JAROSLOVSKY,<sup>3</sup> Bankruptcy Judges.

2  
3 This is an appeal from an order granting a law firm's  
4 interim fee application. The bankruptcy court reduced the law  
5 firm's fees for nondisclosure of its connections with a major  
6 party in interest but overruled objections that the law firm was  
7 disqualified from representing the Chapter 7<sup>4</sup> trustee. We  
8 granted leave to appeal under 28 U.S.C. § 158(a)(3).

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

18 **I. FACTS**

19 Debtor Barry A. Hammer ("Debtor") is an attorney and real  
20 estate developer. He filed his voluntary Chapter 7 petition on  
21 September 17, 2004 (the "Petition Date"). His Chapter 7 trustee,  
22

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23 <sup>3</sup> Hon. Alan Jaroslovsky, Bankruptcy Judge for the Northern  
District of California, sitting by designation.

24 <sup>4</sup> Unless otherwise indicated, all chapter, section and rule  
25 references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330, and  
26 to the Federal Rules of Bankruptcy Procedure, Rules 1001-9036, as  
27 enacted and promulgated prior to the effective date of The  
28 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 Peter H. Arkison ("Trustee"), employed Foster Pepper PLLC as his  
2 attorneys ("Law Firm").

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

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

16 A. Objections to Law Firm's fees

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

23 Creditors object that Law Firm has belatedly and  
24 inadequately disclosed its connections with City, is not  
25 disinterested, and has actual conflicts of interest. At a  
26 preliminary hearing on Friday, July 21, 2006, the bankruptcy  
27 court denied Creditors' request for a 60 to 90 day continuance  
28 for discovery and set an evidentiary hearing for Wednesday, July

1 26, 2006.

2 At oral argument before us, Creditors' counsel clarified  
3 that they are not seeking disgorgement of all of Law Firm's fees  
4 in this case. Instead they believe that Law Firm cannot continue  
5 to represent Trustee as general counsel going forward, they seek  
6 disallowance of any fees incurred on matters involving conflicts  
7 or lack of disinterestedness, and they ask that Law Firm's fees  
8 be further reduced to cover the expense of retaining new counsel  
9 who will have to get up to speed on the case.

10 The following matters are at issue in this appeal.

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

13 Law Firm represented City pre-petition in connection with  
14 City's issuance of approximately \$3.6 million in bonds secured by  
15 sewer assessments on the Property and other real estate. This  
16 project is known as Sewer Improvement Assessment, Local  
17 Improvement District ("LID") 97-1. Law Firm prepared a  
18 disclosure of Debtor's claims for prospective purchasers of the  
19 LID 97-1 bonds. Law Firm stated that those claims "do not appear  
20 to question the validity or enforceability of [the] assessments"  
21 (which Creditors dispute) and that the statutory period "for  
22 filing notices of appeal to the Superior Court from [the]  
23 assessments" has expired without any such notice having been  
24 filed (which appears to be undisputed). Law Firm's work on the  
25 LID 97-1 bonds was not completed until just before the Petition  
26 Date, although Law Firm maintains that the work was substantially  
27 complete in February of 2003.

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

5 To the best of my knowledge, neither I nor  
6 any other person in my office has any connection  
7 with Debtor, the Debtor's creditors, or any other  
8 party in interest, or their respective attorneys  
9 and accountants. \* \* \* I believe [Law Firm] is a  
10 "distinterested person["] for the purposes of  
11 § 101(14) and § 327 of the United States  
12 Bankruptcy Code.

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

24 Ms. Crabbe became aware of these facts in February of 2005  
25 when another of her partners was meeting with Debtor to discuss  
26 his pre-petition claims against third parties. Law Firm  
27 immediately determined not to discuss any claims against City  
28 with Debtor or review any documents related to those claims. Law  
Firm notified Trustee and the Office of the United States Trustee  
("UST") but did not file anything to disclose this issue on the  
record or notify the bankruptcy court.

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

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

15 Ms. Crabbe declared that on the day when she learned about  
16 Law Firm's bond work for City she was leaving on a sixteen day  
17 vacation and "[w]hile I was gone, I completely forgot about the  
18 issue and did nothing about the matter on my return." She  
19 admitted that "[i]n hindsight I should have filed this  
20 supplemental declaration in February 2005" and also stated that  
21 Law Firm was "examining its conflict check input process to  
22 determine how this problem can be avoided in the future."

23 At a hearing on November 23, 2005, Ms. Crabbe told the  
24 bankruptcy court that Law Firm had not done any work for City  
25 since the Petition Date. This was incorrect. Law Firm worked on  
26 at least one matter for City post-petition, and had four open  
27 files for City as of the Petition Date including a general file,  
28 an "Assistant City Attorney" file, and files relating to

1 construction of an emergency radio tower and a special levy. Law  
2 Firm billed City a total of approximately \$5000 in 2004 and 2005.  
3 Creditors state that because the bankruptcy court denied them an  
4 adequate opportunity for discovery, they cannot concede that Law  
5 Firm's post-petition work is unrelated to estate business.

6 Law Firm billed another 0.6 of an hour to City in April of  
7 2006. On July 20, 2006, Ms. Crabbe disclosed this billing and  
8 the other post-petition work described above. She stated that  
9 the "only explanation for this occurrence was a failure of the  
10 firm's conflicts management system." She also disclosed for the  
11 first time that Law Firm is City's primary bond counsel. At the  
12 evidentiary hearing on July 26, 2006, it was revealed that Law  
13 Firm has billed City approximately \$180,000 between 2000 and  
14 2005.

15 C. City's claim against the estate

16 Law Firm filed an omnibus objection to 108 claims, which  
17 proposed to allow City's claim in full as a secured claim to be  
18 paid from proceeds upon sale of the Property. City wrote to Law  
19 Firm requesting clarification that post-petition interest would  
20 be allowed and Ms. Crabbe's daily time records reflect a  
21 telephone conversation with the author of that letter about the  
22 claim. Law Firm then submitted and the bankruptcy court signed  
23 an order allowing City's claim "as a secured claim in the sum of  
24 \$644,942.31 plus any accrued and accruing interest and penalties  
25 to be paid from the proceeds of the sale of the [Property]."  
26 (Emphasis added.) Creditors object to the emphasized language,  
27 which did not appear in Law Firm's original proposed order.

28

1           D.    The estate's claims against City

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

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

19           E.    The plat approval process

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

25           F.    The bankruptcy court's rulings

26           After the evidentiary hearing on July 26, 2006, the  
27 bankruptcy court took the matter under advisement. On August 14,  
28 2006, it issued its oral ruling that there has been no conflict



1 of interest, Law Firm is disinterested, the failure to disclose  
2 Law Firm's relationship with City was the result of mistake or  
3 oversight which "has not prejudiced the estate" or "anyone,"  
4 there is no appearance of impropriety, and "the legal work  
5 performed in this complex and difficult case has been, in my  
6 opinion, outstanding," and "it is difficult for me to imagine the  
7 time and cost to the estate that would be involved in bringing  
8 new counsel up to snuff." Transcript, August 14, 2006, pp. 9:25-  
9 11:7. Nevertheless, as a penalty for Law Firm's "failure to  
10 disclose" the bankruptcy court held that in its discretion it  
11 would deduct \$20,000 from the amount requested and disapprove any  
12 compensation for preparing or defending the fee application. Id.  
13 pp. 11:8-20.

14 On October 11, 2006, the bankruptcy court entered an order  
15 incorporating its oral ruling and awarding Law Firm interim fees  
16 of \$133,104.50 and costs of \$6,793.33. Creditors filed a notice  
17 of appeal. Our clerk issued an order questioning the finality of  
18 the order on appeal and Creditors filed a motion for leave to  
19 appeal, which our motions panel granted over Law Firm's  
20 opposition.<sup>5</sup>

## 21 **II. ISSUE**

22 Did the bankruptcy court err in determining that Law Firm  
23 has had no conflict of interest, is disinterested, is not

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24  
25 <sup>5</sup> We are not bound by the decision of the motions panel but  
26 we agree that leave to appeal was properly granted in this case.  
27 See 28 U.S.C. § 158(a)(3), and, e.g., Travers v. Dragul (In re  
28 Travers), 202 B.R. 624, 626 (9th Cir. BAP 1996) ("Granting leave  
is appropriate if the order involves a controlling question of  
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 disqualified from being compensated, and should not have its fees  
2 further reduced?

### 3 **III. STANDARDS OF REVIEW**

4 Orders on employment, disqualification, and compensation of  
5 professionals are all reviewed for abuse of discretion. Movitz  
6 v. Baker (In re Triple Star Welding, Inc.), 324 B.R. 778, 788  
7 (9th Cir. BAP 2005); COM-1 Info, Inc. v. Wolkowitz (In re Maximus  
8 Computers, Inc.), 278 B.R. 189, 194 (9th Cir. BAP 2002). Whether  
9 a professional is disinterested or a conflict of interest exists  
10 is also reviewed for abuse of discretion. Magten Asset Mgmt.  
11 Corp. v. Paul Hastings et al. (In re Northwestern Corp.), 346  
12 B.R. 84, 87 (D. Del. 2006) (citing In re BH&P Inc., 949 F.2d 1300  
13 (3d Cir. 1991)).

14 A bankruptcy court necessarily abuses its discretion if it  
15 bases its ruling upon an erroneous view of the law. Triple Star,  
16 324 B.R. at 788. Legal issues, including statutory  
17 interpretation, are reviewed de novo. Id.

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

### 22 **IV. DISCUSSION**

23 The bankruptcy court clearly erred in finding that there was  
24 no conflict of interest and that Law Firm was disinterested at  
25 all times. At the very least, Law Firm's review of City's claim  
26 and its involvement in the platting process presented actual  
27 conflicts of interest, or a lack of disinterestedness, or both.  
28 Also, it appears that even now Law Firm might not have been fully

1 candid in its disclosures. We explore these issues, and the  
2 appropriate remedies, below.

3 A. Legal standards

4 Attorneys for the bankruptcy estate are held to a high  
5 standard. Under Section 327(a) they may not "hold or represent  
6 an interest adverse to the estate," and under Section 327(c),  
7 although they are not disqualified "solely" because of employment  
8 by or representation of a creditor, the bankruptcy court "shall"  
9 disapprove their employment upon objection if there is an "actual  
10 conflict of interest." 11 U.S.C. § 327(a) and (c) (emphasis  
11 added).<sup>6</sup>

12 In differentiating subsections (a) and (c) of Section 327,  
13 the courts sometimes distinguish so-called "potential" conflicts  
14

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15 <sup>6</sup> Section 327(a) and (c) state, in full:

16 (a) Except as otherwise provided in this  
17 section, the trustee, with the court's approval,  
18 may employ one or more attorneys, accountants,  
19 appraisers, auctioneers, or other professional  
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 from the "actual conflicts" mentioned in the statute:

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

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

12 Section 327(a) also requires the professional to be a  
13 "disinterested person," defined in Section 101(14) to mean a  
14 person who, among other things, "does not have an interest  
15 materially adverse to the interest of the estate or of any class  
16 of creditors or equity security holders, by reason of any direct  
17 or indirect relationship to, connection with, or interest in, the  
18 debtor . . . or for any other reason[.]" 11 U.S.C. § 101(14) (E)  
19 (emphasis added).

20 The terms "materially adverse" (Section 101(14) (E)) and  
21 "interest adverse to the estate" (Section 327(a)) are not  
22 defined, but

23 A generally accepted definition of "adverse  
24 interest" is the (1) possession or assertion of an  
25 economic interest that would tend to lessen the  
26 value of the bankruptcy estate; or (2) possession  
27 or assertion of an economic interest that would  
28 create either an actual or potential dispute in  
which the estate is a rival claimant; or (3)  
possession of a predisposition under circumstances  
that creates a bias against the estate.

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

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

13 The debate over this issue may be more  
14 semantic than substantive, for a close review of  
15 the [reported] cases indicates that the results  
16 were largely driven by the facts of each case.  
17 And indeed, in the context of section 327, that is  
18 precisely the way it should be. Potential  
19 conflicts, no less than actual ones, can provide  
20 motives for attorneys to act in ways contrary to  
21 the best interests of their clients. Rather than  
22 worry about the potential/actual dichotomy it is  
23 more productive to ask whether a professional has  
24 either a meaningful incentive to act contrary to  
25 the best interests of the estate and its sundry  
26 creditors -- an incentive sufficient to place  
27 those parties at more than acceptable risk -- or  
28 the reasonable perception of one. In other words,  
if it is plausible that the representation of  
another interest may cause the debtor's attorneys  
to act any differently than they would without  
that other representation, then they have a  
conflict and an interest adverse to the estate.

24 In re Leslie Fay Co's, Inc., 175 B.R. 525, 533 (Bankr. S.D.N.Y.  
25 1994) (emphasis added, citations and internal quotation marks  
26 omitted). See also AFI Holding, 355 B.R. at 149 (quoting  
27 authority that 11 U.S.C. § 101(14)(E) covers any interest or  
28 relationship that "would even faintly color the independence and

1 impartial attitude required by the [Bankruptcy] Code”) (citations  
2 omitted); In re Quality Beverage Co., Inc., 216 B.R. 592, 595  
3 (Bankr. S.D. Tex. 1995).

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

10 Valid employment is generally a prerequisite to  
11 compensation,<sup>7</sup> although employment can sometimes be approved  
12 retroactively. Mehdipour, 202 B.R. at 479. There is no quantum  
13 meruit compensation under Section 503, although the bankruptcy  
14 court “has discretion to award or deny compensation for services  
15 outside of a conflict.” Id. at 478-79 (emphasis added)  
16 (citations omitted). See also 11 U.S.C. § 328(c).

17 The above statutory provisions work in tandem with Rule  
18 2014, which states that a professional’s application for  
19 employment “shall be accompanied by a verified statement of the  
20 person to be employed setting forth the person’s connections with  
21 the debtor, creditors, any other party in interest, their  
22 respective attorneys and accountants, the [UST], or any person  
23 employed in the office of the [UST].” Fed. R. Bankr. P. 2014.  
24 This has been interpreted to impose an ongoing duty of  
25 disclosure. In re West Delta Oil Co., Inc., 432 F.3d 347, 355

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26  
27 <sup>7</sup> Section 330(a) provides, in part, that the bankruptcy  
28 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,  
necessary expenses.” 11 U.S.C. § 330(a)(1).

1 (5th Cir. 2005). The penalty for nondisclosure is within the  
2 bankruptcy court's discretion, and can range from nothing (CIC  
3 Inv. Corp., 175 B.R. at 54) to disallowance of all fees. Neben &  
4 Starrett, Inc. v. Chartwell Fin. Corp. (In re Park-Helena Corp.),  
5 63 F.3d 877, 882 (9th Cir. 1995).

6 State and national rules of professional responsibility also  
7 apply, provided that they do not conflict with the Bankruptcy  
8 Code and Rules. See generally AFI Holding, 355 B.R. at 153  
9 n. 15. Washington State's Rules of Professional Conduct ("RPC")  
10 prohibit lawyers from representing current clients with  
11 conflicting interests<sup>8</sup> and limit lawyers' ability to take on any  
12 representation materially adverse to former clients.<sup>9</sup> Conflicts

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14 <sup>8</sup> Rule 1.7 Conflict of Interest: Current Clients

15 (a) Except as provided in paragraph (b) [clients'  
16 informed written consent], a lawyer shall not  
17 represent a client if the representation involves  
18 a concurrent conflict of interest. A concurrent  
19 conflict of interest exists if:

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

22 (2) there is a significant risk that the  
23 representation of one or more clients will be  
24 materially limited by the lawyer's  
25 responsibilities to another client, a former  
26 client or a third person or by a personal  
27 interest of the lawyer. [Emphasis added.]

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

<sup>9</sup> Rule 1.9 Duties to Former Clients

(a) A lawyer who 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

(continued...)

1 can also be imputed from one attorney to another within a law  
2 firm.<sup>10</sup>

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

4 Law Firm reviewed City's claim for Trustee at the same time  
5 as it was representing City. That is impermissible. See  
6 generally Fondiller v. Robinson (In re Fondiller), 15 B.R. 890,  
7 892 (9th Cir. BAP 1981) (noting that reviewing claims "to  
8 determine which should be disputed" is "adverse" to the creditors  
9 holding such claims), appeal dism., 707 F.2d 441 (9th Cir. 1983).

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11 <sup>9</sup>(...continued)

12 materially adverse to the interests of the former  
13 client unless the former client gives informed  
consent, confirmed in writing. [Emphasis added.]

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

15 <sup>10</sup> Washington State's rule on imputation may be less  
16 stringent than other state rules or national model rules:

17 Rule 1.10 Imputation of Conflicts of Interest:  
18 General Rule

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

25 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 See also Tevis, 347 B.R. at 691 (law firm could not have  
2 simultaneously represented clients with adverse interests, even  
3 on unrelated matters).

4 Law Firm characterizes its post-petition work for City as  
5 one or two isolated matters but, as Creditors argue convincingly,  
6 there is substantial evidence that City is an "institutional  
7 client" that consults Law Firm on an "on-call basis."

8 Transcript, July 26, 2006, p.m. Session, p. 86:11. Any contrary  
9 conclusion is not supported by the excerpts of record.

10 The fact that Law Firm was handling only small matters for  
11 City at this particular time is irrelevant. In a comparable case  
12 the bankruptcy court responded, the "short answer to this is that  
13 [the law firm] should be presumed to be loyal to its client" no  
14 matter how "relatively insignificant" that client is. Leslie  
15 Fay, 175 B.R. at 535.<sup>11</sup>

16 Alternatively, even if it were possible to say that Law Firm  
17 did not "represent" City within the meaning of Section 327(a) at

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18  
19 <sup>11</sup> Law Firm argues in a footnote in its brief on appeal  
20 that even if Mr. Voorhees is not disinterested that does not  
21 disqualify the entire firm, citing U.S. Trustee v. S.S. Retail  
22 Stores Corp. (In re S.S. Retail Stores Corp.), 211 B.R. 699, 703  
23 (9th Cir. BAP 1997), app. disp., 162 F.3d 1230 (9th Cir. 1998).  
24 That case is inapposite.

25 Mr. Voorhees has represented City at the same time as Law  
26 Firm was representing Trustee in reviewing and allowing City's  
27 claim. His duty of loyalty to City and any knowledge he might  
28 have regarding weaknesses or strengths of City's claim are  
imputed to Law Firm. This is very different from S.S. Retail, in  
which an attorney at a law firm was an assistant secretary on the  
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 the precise time when it was reviewing City's claim, Law Firm  
2 still "hold[s]" or "ha[s]" interests that are materially adverse  
3 to the estate. 11 U.S.C. §§ 101(14)(E) and 327(a). First, Law  
4 Firm has an incentive not to jeopardize its future relationship  
5 with a client who has paid it approximately \$180,000 in recent  
6 years.

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

22 Law Firm argues that there is no evidence of any actual harm  
23 to the estate, but that argument has several flaws. First,  
24 "[h]arm to the estate is not necessary to a decision to order  
25 disgorgement of fees where there is a conflict of interest." In  
26 re eToys, Inc., 331 B.R. 176, 193 (Bankr. D. Del. 2005). Second,  
27 Creditors were not allowed time for discovery, and discovery  
28 might reveal actual harm. Third, the excerpts of record already

1 do appear to show actual harm in the treatment of City's claim  
2 for penalties.

3 Creditors' Supplemental Objection complains that Law Firm  
4 changed its proposed order to add the phrase "plus any accrued  
5 and accruing interest and penalties" to City's allowed claim.

6 (Emphasis added.) Ms. Crabbe testified that City's claim "has to  
7 include interest" because "it's an oversecured claim."

8 Transcript, July 26, 2006, p.m. Session, p. 23:3-20. See 11

9 U.S.C. § 506(b). That may be so, but Law Firm offers no

10 justification for allowing pre- and post-petition penalties. See

11 11 U.S.C. § 724(a) (avoidance of liens for tax penalties); Norton

12 Bankr. L. & Pract. 2d § 71:2 (same); In re Brentwood Outpatient,

13 Ltd., 43 F.3d 256, 259-65 & n. 5 (6th Cir. 1994) (post-petition

14 tax penalties are not secured under 11 U.S.C. § 506(b) because

15 they arise by operation of law rather than by "agreement"<sup>12</sup>); In

16 re Boardwalk Partners, 171 B.R. 87, 93 (Bankr. D. Ariz. 1994)

17 (penalties disallowed based on "reasonableness" inquiry under 11

18 U.S.C. § 506(b)); Norton Bankr. L. & Pract. 2d § 43:3 at nn. 9-12

19 (tax penalties generally).

20 Instead of raising any objection to City's penalties, Law

21 Firm proposed to allow its claim in full, including \$7,731.33 in

22 pre- and post-petition penalties. Then, in response to City's

23 letter asking for accruing post-petition interest, Law Firm

24 revised its proposed order to include both that interest and

25 accruing penalties. This may be an innocent oversight, or Law

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27 <sup>12</sup> 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 Firm might have good reasons for allowing City's penalty claims,  
2 but Law Firm submitted its revised order with no notice or  
3 explanation of the change in wording. We cannot presume that  
4 there was no harm.

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

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

9 Trustee hired special counsel to evaluate the estate's  
10 claims against City. Special counsel consulted two land use  
11 attorneys, conducted its own research, and concluded that the  
12 State Court Action would be "very expensive [to litigate] with a  
13 very low probability of the [T]rustee prevailing." Creditors  
14 object that Law Firm could have subtly influenced Trustee and  
15 that special counsel did not have adequate time to evaluate the  
16 claims. This is speculation. There is no evidence in the  
17 excerpts of record of any influence exerted by Law Firm nor that  
18 special counsel complained that it had insufficient time.

19 Creditors also object that Law Firm filed a notice of  
20 bankruptcy in one of the State Court Actions. We assume without  
21 deciding that by filing the notice Law Firm preserved a \$12  
22 million action that otherwise would have been dismissed. The  
23 trouble for Creditors is that if anything this benefitted the  
24 bankruptcy estate. There was still an actual conflict of  
25 interest -- Law Firm should not have had any involvement in an  
26 action by one client against another -- but because the estate  
27 was arguably benefitted and the involvement was minimal we  
28 believe that the bankruptcy court had discretion not to

1 disqualify Law Firm or disallow more fees than it did. See  
2 Mehdipour, 202 B.R. at 478.

3 D. Handling of plat approval process with City

4 Creditors' expert on land use law testified that the plat  
5 approval process is inherently adverse to City because "the city  
6 is charged with enforcing its land use codes and getting a good  
7 deal for the public, and the developer is trying to get the best  
8 subdivision they can." Transcript, July 26, 2006, p.m. Session,  
9 pp. 49:22-51:16, 53:10-13. Law Firm attempts to suggest  
10 otherwise, but the bankruptcy court made no findings that would  
11 support this and it appears to us that the plat approval process  
12 is inherently adversarial.

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

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

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

7 11/9/05 Attend meeting with G4 regarding status  
8 of preliminary plat process (4.6  
9 [hours])

10 11/21/05 Telephone conversation with M [Mark H.]  
11 Weber [Regional Assistant U.S. Trustee]  
12 regarding Sultan conflict issue (0.2);  
13 draft supplemental declaration  
14 discussing Sultan conflict issue (0.4);  
15 telephone conversation with P. Arkison  
16 regarding status of plat and meeting  
17 with Group Four (0.2)

18 12/20/05 Attend meeting with G4 and city of  
19 Sultan regarding preliminary plat (3.2)  
20 [Emphasis added.]

21 Law Firm's second and third interim fee applications also  
22 flatly state that Law Firm "worked with" other professionals to  
23 prepare and file a preliminary plat. The third interim  
24 application and Ms. Crabbe's supporting declaration both go  
25 further and state that Law Firm worked with City as well:

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

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

1 discussion.<sup>13</sup>

2 E. Nondisclosure

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

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

15 In mitigation, the bankruptcy court found that the  
16 nondisclosures were the result of mistake or oversight.  
17 Creditors do not challenge that finding. At the evidentiary

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18  
19 <sup>13</sup> Creditors' attorney argued before the bankruptcy court  
20 that Law Firm's connections to City are important not just  
21 because of disinterestedness and conflicts of interest but also  
22 because they could cause costly delays and jeopardize the  
23 development:

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

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

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

1 hearing an attorney for one of the estate's largest creditors  
2 appeared and suggested that this nondisclosure "could happen to  
3 any of us" and "I think a fair thing for the Court to do would be  
4 to say the amount that [Law Firm] billed to [City] is coming off  
5 the top of your bill, end of story." Transcript, July 26, 2006,  
6 a.m. Session, pp. 70:6-71:1.<sup>14</sup> The UST later agreed and  
7 recommended reducing Law Firm's fees by \$5000, or else some  
8 unspecified percentage, "as a sanction for the lack of disclosure  
9 in this case." Transcript, July 26, 2006, p.m. Session,  
10 pp. 62:16-63:25. Instead the bankruptcy court reduced Law Firm's  
11 fees by \$20,000.

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

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23  
24 <sup>14</sup> He also stated, "if you really wanted to make the point,  
25 I'd say . . . wait to get paid for this fee application until  
26 there's a distribution to creditors." Transcript, July 26, 2006,  
27 a.m. Session, p. 71:1-3. The bankruptcy court did that, ordering  
28 Trustee to defer payment of all but \$35,000 in fees "until  
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 F. Remedies

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

24 **V. CONCLUSION**

25 Law Firm cannot represent one client against another. Even  
26 if City was not Law Firm's client at all relevant times, Law Firm  
27 has incentives not to jeopardize its valuable relationship with  
28 City or expose itself to possible liability by exposing any

1 weakness in City's claim for assessments. Therefore Law Firm was  
2 disqualified from reviewing City's claim, let alone recommending  
3 allowance of that claim in full with pre- and post-petition  
4 penalties. Law Firm also improperly involved itself in the plat  
5 approval process with City, despite its protestations that this  
6 is all being handled by the Group Four engineers and surveyors.  
7 The bankruptcy court clearly erred in finding that Law Firm had  
8 no conflict of interest and was at all times disinterested.

9       On remand the bankruptcy court must at a minimum disallow  
10 Law Firm's fees during the time of any actual conflict of  
11 interest or lack of disinterestedness. The bankruptcy court must  
12 also exercise its discretion to determine whether to allow Law  
13 Firm's fees for any other period, and whether Law Firm may  
14 represent Trustee as general or special counsel going forward.  
15 The bankruptcy court's order allowing Law Firm's fees on an  
16 interim basis is REVERSED and this matter is REMANDED.