NOT FOR PUBLICATION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.	**M E M O R A N D U M**[1]
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

Filed - August 17, 2007

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

Honorable Samuel J. Steiner, Bankruptcy Judge, Presiding

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[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.

Before: MONTALI, DUNN and JAROSLOVSKY,[3] Bankruptcy Judges.

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

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

I. FACTS

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

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[3] Hon. Alan Jaroslovsky, Bankruptcy Judge for the Northern District of California, sitting by designation.

[4] Unless otherwise indicated, all chapter, section and rule references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330, and to the Federal Rules of Bankruptcy Procedure, Rules 1001-9036, as 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).

Peter H. Arkison ("Trustee"), employed Foster Pepper PLLC as his attorneys ("Law Firm").

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

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

A. Objections to Law Firm's fees

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

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

26, 2006.

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

The following matters are at issue in this appeal.

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

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

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

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

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

Ms. Crabbe became aware of these facts in February of 2005 when another of her partners was meeting with Debtor to discuss his pre-petition claims against third parties. Law Firm immediately determined not to discuss any claims against City 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.

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

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

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

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

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

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

C. City's claim against the estate

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

D. The estate's claims against City

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

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

E. The plat approval process

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

F. The bankruptcy court's rulings

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

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

On October 11, 2006, the bankruptcy court entered an order incorporating its oral ruling and awarding Law Firm interim fees of $133,104.50 and costs of $6,793.33. Creditors filed a notice of appeal. Our clerk issued an order questioning the finality of the order on appeal and Creditors filed a motion for leave to appeal, which our motions panel granted over Law Firm's opposition.[5]

II. ISSUE

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

[5] We are not bound by the decision of the motions panel but we agree that leave to appeal was properly granted in this case. See 28 U.S.C. § 158(a)(3), and, e.g., Travers v. Dragul (In re 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).

disqualified from being compensated, and should not have its fees further reduced?

III. STANDARDS OF REVIEW

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

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

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

IV. DISCUSSION

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

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

A. Legal standards

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

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

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[6] Section 327(a) and (c) state, in full:

> (a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.
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> * * *
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> (c) In a case under chapter 7, 12, or 11 of this title, a person is not disqualified for 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).

from the "actual conflicts" mentioned in the statute:

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

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

Section 327(a) also requires the professional to be a "disinterested person," defined in Section 101(14) to mean a person who, among other things, "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[.]" 11 U.S.C. § 101(14)(E) (emphasis added).

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

> A generally accepted definition of "adverse interest" is the (1) possession or assertion of an economic interest that would tend to lessen the value of the bankruptcy estate; or (2) possession or assertion of an economic interest that would 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.

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

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

> The debate over this issue may be more semantic than substantive, for a close review of the [reported] cases indicates that the results were largely driven by the facts of each case. And indeed, in the context of section 327, that is precisely the way it should be. Potential conflicts, no less than actual ones, can provide motives for attorneys to act in ways contrary to the best interests of their clients. Rather than worry about the potential/actual dichotomy it is more productive to ask whether a professional has either a meaningful incentive to act contrary to the best interests of the estate and its sundry creditors -- an incentive sufficient to place those parties at more than acceptable risk -- or 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.

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

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

The bankruptcy court does not have authority to allow employment of a professional in violation of Section 327 or Section 101(14). Mehdipour v. Marcus & Millichap (In re 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 retroactively. Mehdipour, 202 B.R. at 479. There is no quantum meruit compensation under Section 503, although the bankruptcy court "has discretion to award or deny compensation for services outside of a conflict." Id. at 478-79 (emphasis added) (citations omitted). See also 11 U.S.C. § 328(c).

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

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[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, necessary expenses." 11 U.S.C. § 330(a)(1).

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

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

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[8] Rule 1.7 Conflict of Interest: Current Clients

> (a) Except as provided in paragraph (b) [clients' informed written consent], a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
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> (1) the representation of one client will be directly adverse to another client; or
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> (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer. [Emphasis added.]

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

[9] 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...)

can also be imputed from one attorney to another within a law firm.[10]

B. Handling of City's claim against the estate

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

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[9](...continued)

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

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

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

> Rule 1.10 Imputation of Conflicts of Interest: General Rule
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> (a) Except as provided in paragraph (e) [pre-existing ethical screen], while lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by Rules 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.

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

We express no opinion whether the Bankruptcy Code and Rules incorporate more stringent rules regarding imputation of 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.

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

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

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

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

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

Mr. Voorhees has represented City at the same time as Law Firm was representing Trustee in reviewing and allowing City's claim. His duty of loyalty to City and any knowledge he might 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.

the precise time when it was reviewing City's claim, Law Firm still "hold[s]" or "ha[s]" interests that are materially adverse to the estate. 11 U.S.C. §§ 101(14)(E) and 327(a). First, Law Firm has an incentive not to jeopardize its future relationship with a client who has paid it approximately $180,000 in recent years.

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

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

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

Creditors' Supplemental Objection complains that Law Firm changed its proposed order to add the phrase "plus any accrued and accruing interest and penalties" to City's allowed claim. (Emphasis added.) Ms. Crabbe testified that City's claim "has to include interest" because "it's an oversecured claim." Transcript, July 26, 2006, p.m. Session, p. 23:3-20. See 11 U.S.C. § 506(b). That may be so, but Law Firm offers no justification for allowing pre- and post-petition penalties. See 11 U.S.C. § 724(a) (avoidance of liens for tax penalties); Norton Bankr. L. & Pract. 2d § 71:2 (same); In re Brentwood Outpatient, Ltd., 43 F.3d 256, 259-65 & n. 5 (6th Cir. 1994) (post-petition tax penalties are not secured under 11 U.S.C. § 506(b) because they arise by operation of law rather than by "agreement"[12]); In re Boardwalk Partners, 171 B.R. 87, 93 (Bankr. D. Ariz. 1994) (penalties disallowed based on "reasonableness" inquiry under 11 U.S.C. § 506(b)); Norton Bankr. L. & Pract. 2d § 43:3 at nn. 9-12 (tax penalties generally).

Instead of raising any objection to City's penalties, Law Firm proposed to allow its claim in full, including $7,731.33 in pre- and post-petition penalties. Then, in response to City's letter asking for accruing post-petition interest, Law Firm revised its proposed order to include both that interest and accruing penalties. This may be an innocent oversight, or Law

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

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

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

C. Handling of the estate's claims against City

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

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

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

D. Handling of plat approval process with City

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

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

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

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

> 11/9/05 Attend meeting with G4 regarding status of preliminary plat process (4.6 [hours])
>
> 11/21/05 Telephone conversation with M [Mark H.] Weber [Regional Assistant U.S. Trustee] regarding Sultan conflict issue (0.2); draft supplemental declaration discussing Sultan conflict issue (0.4); telephone conversation with P. Arkison regarding status of plat and meeting with Group Four (0.2)
>
> 12/20/05 Attend meeting with G4 and city of Sultan regarding preliminary plat (3.2) [Emphasis added.]

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

> [Law Firm] continued to work with Group 4 and the city of Sultan regarding the preliminary plat 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

discussion.[13]

E. Nondisclosure

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

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

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

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[13] Creditors' attorney argued before the bankruptcy court that Law Firm's connections to City are important not just because of disinterestedness and conflicts of interest but also 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. And the delay to the estate could be huge.

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

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.

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

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

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[14] He also stated, "if you really wanted to make the point, I'd say . . . wait to get paid for this fee application until there's a distribution to creditors." Transcript, July 26, 2006, a.m. Session, p. 71:1-3. The bankruptcy court did that, ordering 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.

F. Remedies

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

V. CONCLUSION

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

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

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