

UNITED STATES BANKRUPTCY COURT
DISTRICT OF IDAHO

U. S. COURTS

APR 15 2002

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CAMERON S. BURKE
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In Re:)
)
) Case No. 02-20218
Frank & Sydney Chapin)
) Chapter 11
)
)
Debtor(s))
)

**United States Trustee's Memorandum in Opposition to
Employment of Special Counsel**

The United States Trustee's objects to the employment of Lewis Wilson as special counsel while he retains a security interest against the debtors' residence as part of his employment agreement. The stated purpose of the pre-petition deed of trust is to secure payment of any post-petition attorney fees incurred by Wilson while representing the Chapins. This objection raises a single issue:

In a chapter 11 case, may employment of special counsel be approved where the employment agreement requires a pre-petition security interest to be used to secure payment of post-petition attorney fees when there has been no compliance with 11 USC 364(c) and FRBP 4001(c)?

At the scheduled hearing, Wilson advised the Court that no pre-petition attorney fees remained unpaid.^{1/} And that he desired to retain the deed of trust to secure payment of post-petition attorney fees which may arise through his representation of Chapins. The difficulty with that position is that no motion has been filed requesting approval to obtain credit as required by 11 USC 364(c) nor has any notice as been sent to the twenty largest unsecured creditors advising them that a security interest is sought [FRBP 4001(c)]. As it now stands, the parties appear to believe that approval of Wilson's employment kick starts the security arrangement. But without proper notice to creditors and this Court's approval, Wilson does not have a lien on Chapins' residence to secure payment of his post-petition attorney fees.^{2/}

"Section 364 is applicable to the Debtors. Prior to the appointment of a trustee, the Debtors were fiduciaries of their own estate owing a duty of care and loyalty to the estate's creditors. *In re March*, 995 F.2d 32, 34 (4th Cir.1993). In such cases, § 364 applies to them. *See In re Century Brass Products*, 22 F.3d 37, 39-40 (2d Cir.1994); 2 *Collier on Bankruptcy*, ¶ 364.02, at 364-6 (1996). By incurring secured debt without prior court authorization, the Debtors violated § 364(c)(2). *See Collier's On Bankruptcy*, ¶ 364.04, at 364-11. An appropriate remedy for this disregard is cancellation by the court of the transaction. It is disruptive of bankruptcy for an

^{1/} This resulted from the payment of \$10,000.00 by the debtors pre-petition and a waiver of the remaining balance.

^{2/} *In Re McConville*, 110 F3d 47, 50 (9th Cir. 1997)

estate to obtain fresh credit without regard to the court now supervising the estate.

It is within the power of that court to rescind the contract unlawfully made.”

As Judge Pappas noted in *Parkhurst*^{3/}, even if the Bankruptcy Code does not prohibit the granting of a lien to debtor’s counsel, the existence of a lien could create a conflict and does require compliance with the state’s rules of professional conduct. While only time will tell, an adverse interest could arise between the parties should the security interest be allowed to Wilson and later the Chapins’ decide that a sale of the residence is necessary to fund ongoing operation, a proposed plan or the case becomes administratively insolvent. What is more, should Wilson be allowed a lien, then he would no longer be an administrative expense claimant and instead, must receive payment from the confirmed plan or liquidation of the collateral. A fact which could cause further complications between the parties.

In conclusion, the current request to approve the employment of Wilson must be denied. This is because one of the current terms of employment, the allowance of a lien to secure payment of Wilson’s attorney fees, cannot be authorized as no notice or court approval of the credit arrangement has occurred. The United States Trustee has no objection to the employment of Wilson should he decide to release his security interest and receive payment of his court approved attorney fees as an administrative expense.

^{3/} In Re Parkhurst, Case No. 01-40744; a copy of memorandum is attached.

Dated: 4/11/2002

Mark H. Weber
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**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF IDAHO**

IN RE)
) **Case No. 01-40744**
DAN W. AND SHELLY)
PARKHURST,) **MEMORANDUM OF DECISION**
)
Debtors.)
_____)

Jim Spinner, Esq., Service, Gasser, and Kerl, Pocatello, Idaho, for Chapter 7 Trustee, R. Sam Hopkins.

Jeff Stoker, Esq., for Debtors.

I. Background

On January 17, 2002, the Chapter 7 Trustee, R. Sam Hopkins ("Trustee") filed a Motion to Review and Cancel Fee Arrangement (Docket No. 19) concerning the fee agreement entered into by Dan W. and Shelly Parkhurst ("Debtors"), with their attorney, Jeff Stoker ("Counsel"). Debtors and Counsel filed an Objection and Response to the motion on February 4, 2002 (Docket No. 22). A hearing on the motion and objection was held on February 5, 2002, after which the matter was taken under advisement. This Memorandum constitutes the Court's findings of fact and conclusions of law. Fed. R. Bankr. P. 7052; 9014.

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II. Facts

The facts are undisputed. On April 23, 2001, Debtors filed for relief under Chapter 7 of the Bankruptcy Code. On the same day, Debtors filed their schedules and statements, and Counsel filed his Disclosure of Attorney Compensation pursuant to Fed. R. Bankr. P. 2016(b) (Docket No. 2). In his disclosure, Counsel represented that Debtors had paid him \$475.00 for his services, plus the \$200 filing fee, prior to the filing of their petition. In response to the question in the disclosure form concerning the source of the funds used to pay his fees, Counsel stated "[a]ttorney is a lienholder on Debtors' 1993 Polaris snowmobile." The disclosure also indicates, "In addition, the debtors have agreed to pay the following [to Counsel]: NOT APPLICABLE." Debtor's response to Question No. 9 in their statement of financial affairs concerning payments to their bankruptcy attorney contains, in substance, the same information as disclosed by Counsel.

In fact, Debtors had paid Counsel nothing prior to the filing of the bankruptcy petition. Instead, on March 16, 2001, Debtors had signed a promissory note in favor of Counsel for \$700, which sum was due and payable upon Counsel's

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demand. In the note, Debtors granted Counsel a security interest in the snowmobile to secure the amounts due. Counsel thereafter perfected this security interest by notation of the lien on the certificate of title to the snowmobile. See Exhibits A and B attached to Trustee's Motion to Review and Cancel Fee Arrangement (Docket No. 19). Debtors' Schedule B listed the snowmobile's value as \$700.00, and disclosed Counsel held a lien on the snowmobile. While their Schedule D of secured creditors originally omitted Counsel's secured claim, Debtors later amended the schedule to reflect Counsel's \$700 debt and lien.

Both Trustee and the U. S. Trustee ("UST") assert that Counsel's security interest in Debtor's snowmobile creates a sufficient conflict of interest between Counsel and his clients to warrant cancellation of the lien. Counsel disagrees.

III. Discussion

Trustee filed the Motion to Review and Cancel Fee Arrangement, arguing that Counsel has an impermissible conflict of interest with Debtors which would warrant cancellation of the security interest by the Court, and treatment of

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Counsel's promissory note as general, unsecured debt. Trustee also questions why, if the charge for Counsel's legal services plus filing fee amounted to \$675.00 (i.e., \$475.00 plus the \$200.00 filing fee referred to in Counsel's Rule 2016(b) disclosure and Debtors' statement of financial affairs), Counsel had Debtors sign a promissory note and took a lien in the snowmobile to secure \$700.00. The UST appeared at hearing on Trustee's motion, agreeing with Trustee that Counsel has an impermissible conflict of interest warranting a cancellation of the security interest.

Counsel responds by noting he was simply doing his clients a favor by allowing them to sign a promissory note rather than requiring them to pay his fees and costs "up front" primarily because they could not afford to do so. Counsel defends his lien in the snowmobile asserting that his approach is not substantially different than if the Debtors had been forced to sell the snowmobile at a "fire sale" price to pay his fees in cash before filing for relief. Counsel suggests that since the amount of his fees are not unreasonable,¹ then his fee arrangement should be allowed. Counsel also points out that this fee arrangement allows Debtors to

¹ Neither Trustee nor the UST argue that a \$475 flat fee for representing Debtors in this case is excessive.

retain an asset they would otherwise have to turn over to the Trustee for liquidation to pay unsecured creditors. Finally, Counsel explains that the difference between the amount of the legal and filing fees reflected in his disclosure and the amount of the promissory note is due to his imposition of an additional \$25 fee for preparing the promissory note and to perfect his lien.

None of the parties have cited, nor could the Court through its own research locate, any case law from this Circuit discussing whether it is appropriate for a Chapter 7 debtor's attorney to take a security interest in the debtor's property to secure payment of prepetition attorneys fees. One decision was located from outside the Circuit which holds that an arrangement whereby the Chapter 7 debtor's attorney obtained a promissory note and mortgage in the debtors' real property to secure payment of pre- and postpetition legal fees was both legal and appropriate. *In re Leitner*, 221 B.R. 502, 504 (Bankr. D. Neb. 1998). In that case, the court noted that attorneys and clients almost always occupy the status of creditors and debtors regarding the payment of legal fees. The court specifically declined to conclude that the existence of that relationship, by itself, created a conflict of interest, either ethically or statutorily, such as would disqualify debtor's

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counsel. *Id.* Rather, the court held that any such security interest must be fully disclosed pursuant to Rule 2016(b), would be subject to examination for "excessiveness" under Rule 2017(a), and that although the debtors' personal obligation for the prepetition legal fees would be discharged, the mortgage lien would "pass through" the bankruptcy case unimpaired, thereby continuing to be enforceable by the attorney postbankruptcy. *Id.* at 505-506. No other helpful cases were found with similar facts.

This Court has previously addressed nearly identical facts, albeit in the context of a Chapter 12 case. In *In re Leypoldt*, 95 I.B.C.R. 220, 1995 WL 562183 (Bankr. D. Idaho 1995), an attorney took a security interest in a debtor's snowmobile to secure payment of any legal fees incurred during the bankruptcy case. *Id.* at 220. The Court refused to condone the arrangement, holding that mere existence of the security interest rendered counsel not "disinterested," and created an "adverse interest" as those terms are employed under Bankruptcy Code Sections 327(a) and 101(14), such as to disqualify counsel from representing the Chapter 12 debtor.

The statutory requirements of Section 327 discussed by the Court in

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Leypoldt do not apply to a Chapter 7 debtor's attorney. In Chapter 7, the debtor's attorney is not employed to represent the interests of the bankruptcy estate. A Chapter 7 debtor's attorney need not be disinterested, nor must the attorney be free from any adverse interest in relation to the bankruptcy estate. In fact, the Chapter 7 debtor's interests, and those of his or her attorney, are frequently adverse to the bankruptcy estate represented by the Chapter 7 trustee.

However, some of the concerns regarding the potential for conflict of interest expressed by the Court in *Leypoldt* are relevant here. For example, in *Leypoldt*, the Court compared the effect of a lawyer's receipt of a cash retainer to taking a security interest in the debtor's property to secure the debtor's obligation for unpaid fees:

A cash security retainer is held by the attorney in trust for the debtor thereby removing the property from debtor's possession. In this case, however, Debtors retain possession of the snowmobile and trailer. Consequently, Counsel must monitor Debtors' activities to ensure that the collateral is not utilized in a way that would adversely impact its value. If Counsel believes Debtors are failing to properly preserve the value of the collateral, Counsel is at odds with his clients.

Furthermore, unlike a cash retainer, the value of the snowmobile and trailer is subject to seasonal fluctuation. If Debtors have failed to keep current on their payments to

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Counsel and winter is upon us it will be in Counsel's best interest to press for the surrender of the collateral to take advantage of a favorable market, thereby maximizing the proceeds.

Id. at 226, 1995 WL 562183 at *8. Additionally, the Court questioned why Debtors could not have sold the snowmobile to provide Counsel's retainer, or used the collateral to secure a loan from a nonprofessional third party. *Id.*

The Court is left with similar questions in this case. How were Debtors' interests benefitted by incurring yet another debt to finance their bankruptcy filing, as opposed to selling an item of recreational property to pay their attorney fees and costs? After all, Debtors waited over a month after signing the promissory note to file their bankruptcy petition. This timetable hardly supports the "fire sale" scenario Counsel describes.

Furthermore, Debtor's promissory note to Counsel reflects that payment is "due on demand." In theory, Counsel could have demanded payment in full immediately after the petition was filed, thereby frustrating any significant benefit to Debtors flowing from the arrangement. And, just as in *Leyboldt*, wouldn't Counsel be wise to "demand" payment of this note during the winter, so as to take advantage of seasonal fluctuations in market value for the snowmobile

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should Counsel be required to foreclose upon his lien? Of course, these are hypothetical considerations in the context of this case. However, even if such circumstances do not create an actual conflict of interest between Debtors and Counsel, the potential for such competing interests is present.²

While no provisions of the Bankruptcy Code expressly prohibit the transaction presented by these facts, the provisions of the Idaho Rules of Professional Conduct bear on this issue. One such Rule provides:

(a) A lawyer shall not enter into a business transaction with a

² As this Court noted in *Leypoldt*,

[D]istinguishing between "actual" and "potential" conflicts is an imprecise exercise because the terms merely describe different stages in the same relationship. An actual conflict is one in which there is active competition between two interests, and in which one interest can only be served at the expense of another. A potential conflict exists until the competition begins, but its existence may still impact the actions of the parties.

....

Put another way, the presence of a "potential" conflict can change circumstances so that the die is cast by the time the conflict becomes "actual." Human frailty is such that this occurs even if the professional attempts in good faith to represent both interests fairly.

Leypoldt, 95 I.B.C.R. at 223, 1995 WL 562183 at *4-5. Therefore, the Court found no reason to distinguish between actual and potential conflicts of interests in its analysis. *Id.* at 224, 1995 WL 562183 at *5.

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client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

- (1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which can be reasonably understood by the client;
- (2) the client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and
- (3) the client consents in writing thereto;

Rule 1.8, Idaho Rules of Professional Conduct (*emphasis added*). In this regard, the Trustee and UST raise important questions concerning whether all the consequences flowing from this transaction were fully disclosed by Counsel to Debtors.

For instance, did Counsel inform his clients of alternatives available to them for payment of his fee, and that he could seek payment from the bankruptcy estate for legal fees as an administrative expense, even without taking a security interest in their snowmobile? *See In re Century Cleaning Services, Inc.*, 195 F.3d 1053, 1061 (9th Cir. 1999). Did Counsel reveal that by taking the security interest he placed himself ahead of other priority unsecured claimants, including any nondischargeable taxes? Did Counsel inform his clients that any obligation remaining for his prepetition legal services would be subject to discharge absent

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the lien on their snowmobile? *See American Law Center, PC v. Stanley (In re Jastrem)*, 253 F.3d 438, 442 (9th Cir. 2001). Trustee and UST are also concerned about whether Counsel exercised appropriate judgment regarding valuation of the snowmobile for purposes of his lien and for full disclosure on Debtors' schedules. Was it mere coincidence that both the value of the snowmobile and the amount owed to Counsel were the same? These questions highlight the potential for problems when a debtor's attorney takes a security interest in the client's property to secure payment of fees.

Finally, the Ninth Circuit and this Court have repeatedly held that anything less than strict compliance with Section 329(a) and Rule 2016(b) can justifiably result in denial of *all* requested fees. *Law Offices of Nicholas A. Franke v. Tiffany (In re Lewis)*, 113 F.3d 1040, 1045 (9th Cir. 1997); *In re Combe Farms, Inc.*, 01.1 I.B.C.R. 7, 9, 257 B.R. 48, 53 (Bankr. D. Idaho 2001) ("the requirements of these provisions of the Code and Rules are not merely aspirations or goals; timely and strict compliance by counsel is mandatory."). To enforce the requirement of full, accurate disclosure on the Rule 2016(b) statement, the Ninth Circuit has held that the bankruptcy court has inherent authority to reduce a

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debtor's attorney's compensation in conjunction with Sections 327, 329, 330, and 331. *Id.* Moreover, a decision to require denial or disgorgement of fees does not necessarily require a finding of excessiveness. *Id.* Because this Court has the authority under Section 329 and its inherent powers to deny all fees, it should follow that, if the circumstances require, the Court has the authority to do something less than deny all fees, *i.e.* to cancel the security interest in Debtors' snowmobile.

As noted above, there is no statutory prohibition preventing a Chapter 7 debtor's attorney from taking a security interest in the debtor's property to secure the debtor's obligation to pay fees. The Court will not presume to create such a proscription. However, under such circumstances, Counsel should expect heightened scrutiny of the propriety of the fee arrangement. In particular, Counsel's Rule 2016(b) disclosure must fully, completely and accurately detail all material terms of the fee agreement. Moreover, debtor's counsel should expect, when requested, to demonstrate full compliance with the duties imposed upon Idaho attorneys by Rule 1.8 of the Idaho Rules of Professional Conduct to ensure no actual or potential conflict of interest exists in counsel's dealings with the

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debtor.³ If debtor's attorney fails to properly disclose the fee arrangement under Rule 2016(b), or if the lawyer fails to adequately show his or her duty under Idaho Rule 1.8(a) has been discharged, upon request by the Chapter 7 trustee, U.S. Trustee or other interested party, or upon the Court's own motion, and under authority of the statutes and rules cited above, as well as the Court's inherent powers under 11 U.S.C. § 105(a), the Court may cancel the attorney's security interest.

In this particular case, Counsel's Rule 2016(b) disclosure is admittedly inaccurate and incomplete. It reflects payments to Counsel which were not in fact made, and incorrectly states the amount of the attorneys fees and costs as \$675, instead of \$700. It also makes no mention of the fact that Counsel holds a demand note from his clients for his unpaid fees and costs. In short, Counsel's Rule 2016(b) disclosure is legally inadequate.

Moreover, there is nothing in the record to show Counsel has satisfied his ethical obligations and the conditions imposed by Rule 1.8(a)(1)-(3)

³ Courts in several districts have concluded that violations of state ethical rules are relevant in fee determinations. See, e.g., *In re Soultisak*, 227 B.R. 77, 82 (Bankr. E.D. Va. 1998); *In re Wilde Horse Enterprises, Inc.*, 136 B.R. 830, 844 (Bankr. C.D. Cal. 1991); and *In re 437 Park Corp.*, 54 B.R. 326, 300 (Bankr. S.D. N.Y. 1985).

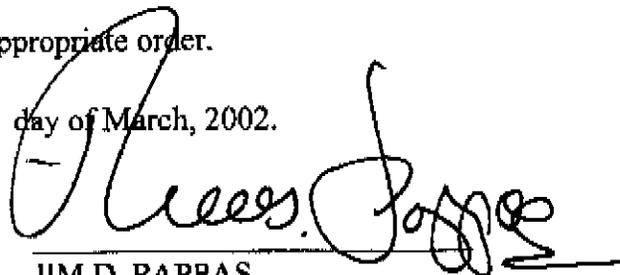
with respect to this fee arrangement. That Rule requires proof that Counsel fully disclosed the potential pitfalls and burdens of the transaction, that they were given an opportunity to consult with other legal counsel, and that they fully appreciated the consequences and consented to details of this arrangement.

IV. Conclusion

After due consideration of the facts and record herein, and in the exercise of its discretion, the Court concludes that the security interest retained by Counsel in Debtors' snowmobile should be deemed canceled and unenforceable as a sanction for Counsel's failure to comply with the statutes and rules cited above.

The Court will enter an appropriate order.

DATED This 22nd day of March, 2002.



JIM D. PAPPAS
CHIEF U.S. BANKRUPTCY JUDGE

CERTIFICATE OF MAILING

I, the undersigned, hereby certify that I mailed a true copy of the document to which this certificate is attached, to the following named person(s) at the following address(es), on the date shown below:

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CASE NO.: 01-40744

CAMERON S. BURKE, CLERK
U.S. BANKRUPTCY COURT

DATED: March 22nd, 2002

By *Siame J. Hutchinson*
Deputy Clerk

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