

U.S. Bankruptcy Court
District of Idaho
Filed: April 25, 2002
at 9:30 AM
By: jc *jc*

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF IDAHO**

IN RE)
)
FRANK CHAPIN,) Case No. 02-20218
SYDNEY CHAPIN,)
) MEMORANDUM OF DECISION
Debtors.)
)
_____)

Bruce A. Anderson, ELSAESSER JARZABEK ANDERSON MARKS & ELLIOTT,
CHTD., Sandpoint, Idaho for Debtors.

Gary L. McClendon, Office of the U.S. Trustee, Boise, Idaho.

Michael J. Paukert, PAINE, HAMBLEN, COFFIN, BROOKE & MILLER, LLP,
Spokane, Washington, for Creditors American Lutheran Church, *et al.*

Lewis M. Wilson, Spokane, Washington, proposed Special Counsel.

BACKGROUND AND FACTS

On February 22, 2002, Frank Chapin and Sydney Chapin ("Debtors") filed a joint petition for relief under chapter 11. Though their schedules would not be filed for some time, their list of creditors under Fed.R.Bankr.P. 1007(d) indicated significant pending litigation. See Doc. No. 2. The schedules and statement of financial affairs filed a month later confirmed this. See Doc. No. 13.

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The Debtors sought to have their employment of attorney Bruce Anderson as general bankruptcy counsel approved by the Court. See § 327(a). That approval was granted. They also sought approval of their employment of an attorney, Lewis M. Wilson, as special counsel for purposes of handling their Washington state court litigation. See "Application for Appointment of Special Counsel and Notice" (the "Application"), Doc. No. 4, filed February 28, 2002. The Application, signed by Frank Chapin, recites:

To the best of the applicant's knowledge, there are no connections of the person proposed to be employed with the debtor, creditors, other parties in interest, and the U. S. Trustee.

Id. at p. 2. The Application was followed a week later with a "Verified Statement of Special Counsel" (the "Verification"). See Doc. No. 8, filed March 7, 2002. In the Verification, Mr. Wilson declared, in full:

I, LEWIS M. WILSON, declare under penalty of perjury as follows:

I am an attorney and make this statement upon personal knowledge. I have read the Application for Appointment of Special Counsel filed in this matter, know the contents thereof, and that the facts therein stated are true, to the best of my knowledge, information, and belief.

The lawyers proposed to be employed, Lewis M. Wilson, is experienced in handling civil cases in the Eastern District of Washington, in Spokane County. I am currently representing Frank Chapin in the matters in Spokane County.

I further state that this law firm has no connection with the above-named debtor, the creditors of the estate, or any party in interest, their respective attorneys and accountant, the United States Trustee, or any person employed in the office of the United States Trustee.

On the date of filing, my firm was owed \$1,857.90, which fees are hereby waived.

Id. at p. 1-2.

Though the Application did not refer to the Code provision under which it was presented, it appears clear from the record that approval of Mr. Wilson's employment is sought under § 327(e) rather than under § 327(a).

The Application was served on all creditors with notice of an opportunity to object. See Doc. No. 4, at p. 3-6; see *also*, Local Bankruptcy Rule 2014.1. An objection to the approval of Mr. Wilson's employment was filed by certain of the Debtors' adversaries in the state court litigation. See "Objection to the Employment of Lewis Wilson as Special Counsel for Debtors" (the "Objection"), Doc. No. 12, filed March 14, 2002. The Objection raised an issue concerning the prebankruptcy granting of a deed of trust by the Debtors in favor of Mr. Wilson. Attached to the Objection as an exhibit was a copy of a February 2, 2002 deed of trust against the Debtors' Bonner County real property in order to secure payment of up to \$50,000.00 in Mr. Wilson's legal fees.

Under LBR 2014.1(c), the existence of the Objection required the Application to be brought on for hearing. That hearing was held on April 9, 2002.¹

¹ That Local Rule provides that, "[i]f an objection to the application is timely filed, then the applicant shall schedule a hearing" The applicant (*i.e.*, the Debtors) did not do so. The Court instructed the clerk to advise counsel that a hearing was needed. In some fashion, a hearing date of April 9 was obtained. It is not clear who did so. No notice of hearing appears of record. However, Messrs. Anderson and Wilson appeared on April 9, as did the United States Trustee. The Court surmises that the appearing parties may have become aware of the setting by monitoring the Court's calendar. The Court concludes that, under all the circumstances, the lack of formal notice and the absence of the Objectors at hearing do not mandate further hearing.

At this hearing, the U.S. Trustee raised concerns about the deed of trust and the propriety of approval of Mr. Wilson's employment. Mr. Wilson defended on both counts. The matter was taken under advisement subject to post-hearing briefing by the U.S. Trustee and Mr. Wilson.

The U.S. Trustee's brief in opposition was filed on April 15. On April 23, Mr. Wilson filed an "Amended Verified Statement of Special Counsel." See Doc. No. 25 (the "Amended Verification"). In it, he now acknowledges receiving the February 7, 2002 deed of trust. Mr. Wilson further states:

I expressly herein agree to reconvey such deed of trust. Any fees incurred, with respect to my services post-petition, shall be of no different character or priority than that of other professionals.

Amended Verification, at p. 2.

This contested matter is now ripe for determination. This decision constitutes the Court's findings and conclusions on the same. Fed.R.Bankr.P. 9014, 7052.

DISCUSSION AND DISPOSITION

Employment of special counsel, *i.e.*, an attorney other than the one responsible for the general conduct of the bankruptcy case, is governed by § 327(e) which provides:

(e) The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.

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While the strict disinterestedness standard applicable to general counsel² does not apply to special counsel, such a professional must still be free from adverse interest to the debtor or to the estate with respect to the matters on which he is to be employed. See generally, *In re Salmon River Canal Co., Ltd.*, 93 I.B.C.R. 208, 209 (Bankr. D. Idaho 1993) (explaining function and operation of § 327(e)). The primary concern raised by the objecting creditors and the U. S. Trustee - and even by Mr. Wilson in his comments at hearing - is that the existence of a security interest in Debtors' residential real property creates or potentially creates such a disqualifying adverse interest.³

The Bankruptcy Appellate Panel has concluded that the existence of a security interest in favor of the professional, encumbering assets of the debtor's estate, is not adverse *per se* within the contemplation of § 327(e). *Film Ventures International v. Asher (In re Film Ventures International)*, 75 B.R. 250, 252 (9th Cir. BAP 1987). The question of adverse interest which disqualifies proposed special

² See *In re Overacker*, 02.1 I.B.C.R. 55 (Bankr. D. Idaho 2002) (addressing § 327(a) and the requirements which have developed regarding strict disinterestedness, discussing *In re Omnisports*, 92 I.B.C.R. 147 (Bankr. D. Idaho 1992) and *In re Dugger*, 99.1 I.B.C.R. 30, 32 (Bankr. D. Idaho 1999)); see also, *First Interstate Bank of Nevada, N.A. v. CIC Investments Corporation (In re CIC Investments Corporation)*, 175 B.R. 52, 56 (9th Cir. BAP 1994).

³ The Court appreciates that Mr. Wilson on April 23 agreed to release the deed of trust. The issues presented are serious enough, however, to justify analysis and discussion.

counsel is, instead, case and fact-specific. *Id.*; see also, *In re Fretter, Inc.*, 219 B.R. 769, 777-78 (Bankr. N.D. Ohio 1998).

In this case, the record indicates that Mr. Wilson was paid \$10,000.00 on January 1, 2002. This was apparently through a draw down on or exhaustion of an existing retainer.⁴ This left \$1,857.90 outstanding, which amount was waived by Mr. Wilson at the time of the petition on February 22.⁵ Additionally, the deed of trust designed to secure up to \$50,000 in future fees was bargained for and received on February 2, 2002, just 20 days before filing.

In addition to evaluating the existence of adverse interest, the Court must consider the fact that Mr. Wilson did not disclose the payment or the existence of the deed of trust in his Verification, as required under Rule 2014(a) and LBR 2014.1(a).

This Court has repeatedly emphasized the serious nature of professionals' compliance with disclosure rules. For example, it has held:

[A] failure to disclose any fact which may influence the court's decision may result in a later determination that disclosure was inadequate and sanctions should be imposed on the professional.

⁴ The factual scenario comes from the Debtors' response to question no. 9 in their statement of financial affairs, and from comments of counsel at the April 9 hearing. There was no disclosure filed by Mr. Wilson under § 329(a) or Rule 2016(b), nor was the explanation made more complete in the Amended Verification under Rule 2014.

⁵ It is thus at least inferentially suggested that Debtors had incurred an obligation for unpaid legal fees of \$11,857.90 over some period of time. No other information regarding this debt, or the transfer in January, has been provided. The Court expresses no opinion on the propriety of this transfer.

In re Combe Farms, 257 B.R. 48, 54, 01.1 I.B.C.R. 7, 10 (Bankr. D. Idaho 2001), quoting 9 L. King, *Collier on Bankruptcy*, ¶ 2014.03, 2014-5-6 (15th ed. 1997).

Combe Farms noted that failure to comply fully with the rules justifies disallowance of employment approval and/or disallowance of fees. 257 B.R. at 55, n.14, 01.1 I.B.C.R. at 10, n.14, citing *Neben & Starrett, Inc. v. Chartwell Financial Corporation (In re Park-Helena Corporation)*, 63 F.3d 877, 882 (9th Cir. 1995), and *In re Begun*, 162 B.R. 168, 177 (Bankr. N.D. Ill. 1993) (Rule 2014 leaves no discretion to the professional to choose what connections are relevant or trivial; all must be disclosed).⁶

The Court also found it "absolutely essential" that it "not simply 'excuse' counsel where compliance falls short..." 257 B.R. at 53-54, 01.1 I.B.C.R. at 9. The nature of the Court's response can vary, however, since it has "broad discretion" in designing appropriate remedies for dealing with violations of Rule 2014. 257 B.R. at 55, n.15, 01.1 I.B.C.R. at 10, n. 15, citing *Park-Helena*, 63 F.3d at 882, and *Film Ventures*, 72 B.R. at 253. *See also, Fretter*, 219 B.R. at 776, 780.

Receiving a \$10,000 payment and a deed of trust on the eve of bankruptcy clearly are not inconsequential connections. A real possibility of adversity was created by the secured position in the Debtors' residence which was granted in

⁶ In fact, *Collier* suggests that the better practice is to treat a Rule 2014(a) statement as a pleading which merits careful preparation and review, and to err on the side of over-disclosure. *Id.* at ¶ 2014.03, quoted at 257 B.R. 54, 01.1 I.B.C.R. at 9.

favor of Mr. Wilson.⁷ The failure to fully and candidly disclose these material facts is a patent violation of Rule 2014(a).⁸ Even more unsettling was Mr. Wilson's apparent attitude toward the disclosure requirements, as evidenced by his comment at the April 9 hearing that he was "just signing forms."

Whether by virtue of a post-hearing change of heart and agreement with the concerns voiced, or just by a desire to avoid review and possible censure, Mr. Wilson now agrees to release the deed of trust. However, the Court will not simply accept the concession. The Court cannot and should not ignore the failure to abide by the standards and requirements that apply to retention of professionals, particularly the disclosure obligations of Rule 2014(a).

For the reasons set forth above, and as a sanction for violation of the applicable Rules and standards, the Court will expressly nullify the deed of trust and order it canceled, and shall require Mr. Wilson to file a release and reconveyance thereof in the Bonner County records.

This approach finds analogous support in the recent decision of Chief Bankruptcy Judge Pappas in *In re Parkhurst*, 02.1 I.B.C.R. 57 (Bankr. D. Idaho

⁷ As this Court has previously observed, attempting to distinguish between "actual" and "potential" conflicts is an imprecise exercise because the terms simply describe different stages in the same relationship, and that even a potential conflict can still materially impact the actions and conduct of the parties. *In re Leypoldt*, 95 I.B.C.R. 220, 223-24 (Bankr. D. Idaho 1995).

⁸ The Court would also view the failure to disclose the deed of trust in connection with the Application as a violation of Idaho Rules of Professional Conduct 3.3, and in particular Rule 3.3(d).

2002). There a chapter 7 debtors' attorney received a security interest in a chattel prior to filing, and failed either to properly disclose the facts surrounding that grant or to establish that the security interest was obtained in compliance with the requirements of the Idaho Rules of Professional Conduct.⁹ Similar to the situation here, the existence of the security interest was not a *per se* disqualification. 02.1 I.B.C.R. at 58. However, given an inadequate record to establish that the lawyer met the obligations of IRPC 1.8 and given a failure to fully comply with Bankruptcy Code and Rule requirements, the Court canceled the security interest. 02.1 I.B.C.R. at 59.¹⁰

It appears from the Amended Verification that the Debtors still want Mr. Wilson to represent them in the Washington state court litigation as special counsel and that Mr. Wilson would agree to continue in that role despite being stripped of his security interest.

The Court continues to have some concern over the possibility of adverse interest since the facts and circumstances of the January and February 2002 transfers remain unclear. However, the Court will approve the proposed employment under

⁹ The Court discussed the several requirements imposed by Idaho Rule of Professional Conduct 1.8(a)(1) through (3), and found that the record was devoid of proof that those ethical obligations and conditions were satisfied. 02.1 I.B.C.R. at 58-59.

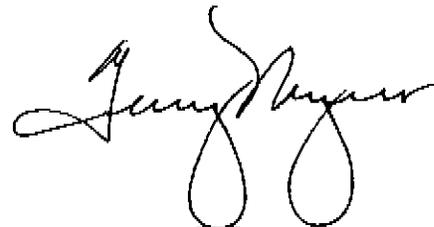
¹⁰ In *Parkhurst*, the lawyer's Rule 2016(b) disclosures were found inadequate and incomplete since they reflected a payment of \$475.00 which hadn't in fact been made, incorrectly stated the agreed fee for the case would be \$675.00 instead of \$700.00, and failed to mention the existence of a demand note, even though the security interest in the chattel was disclosed. 02.1 I.B.C.R. at 57, 59.

§ 327(e). In doing so, the Court observes that all compensation to Mr. Wilson will be subject to the strictures of the Code. If and when properly allowed under §§ 330 and 331 and applicable rule, his compensation will be an administrative expense. See § 502(b)(3). It will thus share the same rank and priority as other allowed chapter 11 administrative expenses in this case, to be treated in the Debtors' plan or as otherwise may be required by the Code. Additionally, should an adverse interest develop or be shown to exist, Mr. Wilson's employment may be terminated and his compensation may be lost.

CONCLUSION

Based on the foregoing, an order will be entered determining and providing that the deed of trust granted to Mr. Wilson shall be canceled and be of no further effect, and requiring Mr. Wilson affirmatively to release the same of record. The Application will otherwise be granted. Mr. Wilson shall submit a form of order, endorsed by the U.S. Trustee, which is consistent with this Decision.

Dated this 25th day of April, 2002.



TERRY L. MYERS
UNITED STATES BANKRUPTCY JUDGE

CERTIFICATE OF SERVICE

I, the undersigned, hereby certify that I served by the method indicated below, 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:

DATED: April 25, 2002
Case No. 02-20218 (Frank Chapin)

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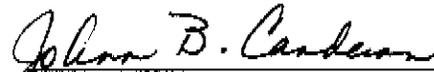
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