UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA

In re: BKY 4-90-6127

BENJAMIN'S-ARNOLDS, INC.,

Debtor.

MEMORANDUM ORDER DENYING MOTION FOR SUMMARY JUDGMENT IN PART AND GRANTING MOTION FOR SUMMARY JUDGMENT IN PART

At Minneapolis, Minnesota, February 27, 1997.

The above-entitled matter came on for hearing before the undersigned on a motion for summary judgment by Larkin, Hoffman, Daly and Lindgren, P.A. ("Larkin"). Appearances were as noted in the record. The Court has heard the arguments of counsel, read the papers and exhibits, and, being duly advised in the premises, renders the following decision:

FACTS

1. On October 30, 1990, the Debtor, Benjamin's-Arnolds, Inc., ("Debtor") filed a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code. At the time, the shareholders of the Debtor were Roger Moberg, Larry Anderson, Michael Chamberlain, and Lakeland Avenue Properties.

2. In accordance with 11 U.S.C. § 327 and Bankruptcy Rule 2014, on November 5, 1990, Debtor filed an application to retain counsel Michael LeBaron and the Larkin law firm. The application was signed by Roger Moberg and was accompanied by an affidavit of Michael LeBaron. The application stated that, with the exception

of the fact that Larkin was an unsecured prepetition creditor of the Debtor, Larkin did not hold or represent any interest adverse to the estate and was disinterested. LeBaron's affidavit stated:

> Neither the undersigned nor the firm of Larkin, Hoffman, Daly & Lindgren, Ltd. hold or represent any interest adverse to the interest of the Debtor in the above reorganization proceeding and are disinterested to the extent required by law, except that Larkin, Hoffman, Daly & Lindgren, Ltd., is a general unsecured creditor of the Debtor for unpaid attorney's fees incurred by the Debtor in its regular course of business more than 90 days before the filing of Debtor's petition.

The application and affidavit made no disclosure with respect to many facts which have since come to light. For example, the affidavit made no mention of the fact that Larkin had a longstanding attorney-client relationship with virtually all of the shareholders and their related affiliates; that one hour prior to the filing of the petition Larkin had assisted in arranging for Chamberlain, without additional consideration, to take a security interest in the Debtor's assets in the sum of over $840,000; that soon prior to the filing of the case Larkin had been paid $17,000 in attorneys fees, that there had been additional payments to Larkin within the preference period, and that some of these fees were for bankruptcy-related work; or, that Larkin had and would continue during the case to represent the principals and related entities, some of whom were creditors of the Debtor. The Trustee asserts that these, and other facts, would have disqualified Larkin from serving as counsel for the Debtor.

3. By Order dated November 20, 1990, I approved the retention of Larkin as counsel for the Debtor. Larkin served as counsel for the Debtor throughout the course of the further proceedings in the case.

4. During the case, Larkin filed two fee applications. The first, Larkin's Application for Interim Compensation and Expenses was dated February 21, 1991 in the amount of $83,933.31 and was approved by Order dated March 28, 1991. The second, Larkin's Application for Final Allowance of Fees and Expenses was dated September 3, 1992, in the amount of $292,574.69 (including the previously allowed interim fees) and was approved by Order dated October 2, 1992. Each application stated that the services for which Larkin sought to be paid were performed for the Debtor "and not on behalf of any Committee, creditor, or other person."

5. Debtor paid Larkin $103,553.73 of the amounts allowed by the Court's Order of October 2, 1992. There is an outstanding balance due in the sum of $189,020.96.

6. Debtor's Plan of Reorganization was confirmed by Order of this Court entered on August 5, 1992. The Plan and the Order confirming it provided that all property of the Debtor's estate revested in the Debtor on the effective date of the Plan. The Plan further provided that the Debtor would transfer all contracts evidencing receivables and all other proceeds of its

liquidation to a collection and disbursing agent upon confirmation. The Plan further required that the agent make monthly payments to the holders of allowed administrative expenses, including compensation and reimbursement of expenses allowed to Larkin, from the proceeds of the Debtor's property recovered by the agent. Finally, the Plan required that the agent pay all postconfirmation legal fees and expenses incurred by the Debtor in connection with various postconfirmation activities on a current basis from the proceeds of the Debtor's property. During the postconfirmation period, Larkin billed the Debtor for $32,295.31 for services rendered in connection with liquidating its assets. Those fees were paid by the Debtor, except for $3,296.00 which remains unpaid.

7. By Order dated March 22, 1993, the bankruptcy case was closed.

8. By Order dated July 11, 1994, this case was reopened.

9. By Order dated October 5, 1994, the case was converted to a Chapter 7.

10. Larkin has filed four claims in the Chapter 7 case, Claim Numbers 117, 118, 121, and 122. These claims are for unpaid preconfirmation ($189,020.96) and unpaid postconfirmation ($3,296.00) services rendered to the Debtor both in connection with the case and prior thereto.

11. On July 12, 1996, the Trustee filed a motion objecting to Larkin's claims and seeking disgorgement of the $103,553.73 in

postpetition/preconfirmation fees and of the $29,771.33 in postpetition/postconfirmation fees that had been paid to Larkin in connection with the Chapter 11 case.[1] The parties agreed to a discovery schedule. Many depositions were completed and discovery is now closed. Based on new discoveries, the Trustee amended his motion on November 13, 1996. The amended motion contained much more extensive and detailed allegations of improprieties on Larkin's part and, for the first time, asserted a right to disgorgement, pursuant 11 U.S.C. § 329, of fees that had been paid to Larkin during the one year prior to the petition. The Trustee has also sought expanded relief in the form of an order vacating the order authorizing Larkin's retention and the two orders allowing fees. Over the objection of Larkin, I allowed the amendment to the Trustee's motion and reopened discovery going exclusively to the newly-added request for prepetition attorneys' fees and expenses.[2]

12. On November 14, 1996, Larkin moved for partial summary judgment on that part of the Trustee's motion which seeks disgorgement of the sums paid to Larkin as postpetition/

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[1] The Trustee has also filed an adversary proceeding, the counts of which overlap the issues addressed in this motion to some extent, but which also include claims such as a malpractice claim which could not be brought by way of motion.

[2] These fees and Larkins' activities with respect thereto are not being considered as part of this motion for summary judgment.

preconfirmation fees and as postpetition/postconfirmation fees. The Trustee opposes that motion.[3]

DECISION

A. STANDARDS FOR SUMMARY JUDGMENT

Summary judgment is governed by Federal Rule of Civil Procedure 56, and is made applicable to this matter by Bankruptcy Rules 7056 and 9014. Federal Rule 56 provides:

> The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law.

FED. R. CIV. P. 56(c). The moving party on summary judgment bears the initial burden of showing that there is an absence of evidence to support the nonmoving party's case. Celotex Corp. v. Catrett, 477 U.S. 317, 325 (1986). If the moving party is the plaintiff, it carries the additional burden of presenting evidence that establishes all elements of the claim. Id. at 324; United Mortgage Corp. v. Mathern (In re Mathern), 137 B.R. 311, 314 (Bankr. D. Minn. 1992), aff'd, 141 B.R. 667 (D. Minn. 1992).

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[3] The Trustee has also made his own motion for summary judgment seeking an order requiring the disallowance and disgorgement of all fees and expenses that have been allowed or paid. This Memorandum Order addresses only the summary judgment motion brought by Larkin. The Court will issue a separate order addressing the Trustee's motion for summary judgment.

The burden then shifts to the nonmoving party to produce evidence that would support a finding in its favor. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 250-52 (1986). This responsive evidence must be probative, and must "do more than simply show that there is some metaphysical doubt as to the material fact." Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 586 (1986).

B. PROVISIONS AUTHORIZING THE EMPLOYMENT AND COMPENSATION OF PROFESSIONAL PERSONS BY THE ESTATE

Larkin's motion in this case implicates a number of provisions of the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure that deal with the employment and compensation of professional persons by the estate. Before addressing the merits of the arguments of counsel, it is appropriate to address these provisions in some detail.

In conjunction with 11 U.S.C. § 1107(a),[4] § 327 of the Bankruptcy Code authorizes a debtor in possession, subject to the court's approval, to employ one or more professional persons to represent or assist the debtor in possession in carrying out its duties under the Bankruptcy Code. Section 327 provides, in part:

> (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.

11 U.S.C. § 327(a) (1994) (emphasis added). Therefore, pursuant to § 327(a), a debtor in possession may not employ any professional person who either: 1) holds or represents an interest adverse to the estate; or 2) is not disinterested.

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[4] With certain limitations, § 1107(a) provides a debtor in possession with all the rights and powers of a trustee in bankruptcy. Section 1107(a) provides:

> Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in sections 1106(a)(2), (3), and (4) of this title, of a trustee serving in a case under this chapter.

11 U.S.C. § 1107(a) (1994). This provision gives the debtor in possession the right to employ professional persons in accordance with § 327.

Pierce v. Aetna Life Ins. Co. (In re Pierce), 809 F.2d 1356, 1362 (8th Cir. 1987).[5]

The phrase "holds or represents an interest adverse to the estate" is not defined in the Bankruptcy Code. Numerous courts, however, have adopted the definition of the phrase that was set forth in In re Roberts, 46 B.R. 815 (Bankr. D. Utah 1985):

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[5]There are three limited exceptions to this general rule. Section 327(c) provides:

> In a case under chapter 7, 11 or 12 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(c) (1994) (emphasis added). Similarly, § 327(e) provides:

> 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.

11 U.S.C. § 327(e) (1994). Finally, § 1107(b) provides:

> Notwithstanding section 327(a) of this title, a person is not disqualified for employment under section 327 of this title by a debtor-in-possession solely because of such person's employment by or representation of the debtor before the commencement of the case.

11 U.S.C. § 1107(b) (1994).

(1) to possess or assert any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant; or

(2) to possess a predisposition under circumstances that render such a bias against the estate.

Id. at 827. See also Electro-Wire Products, Inc. v. Sirote & Permutt, P.C. (In re Prince), 40 F.3d 356, 361 (11th Cir. 1994); In re Rusty Jones, Inc., 134 B.R. 321, 342 (Bankr. N.D. Ill. 1991); In re Al Gelato Continental Desserts, Inc., 99 B.R. 404, 407 (Bankr. N.D. Ill. 1985). An attorney is disqualified if the attorney either falls into this definition or represents somebody who falls within this definition. Rusty Jones, 134 B.R. at 342.

Unlike the phrase "interest adverse," the term "disinterested" is defined by the Code in 11 U.S.C. § 101(14).[6]

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[6]The full text of § 101(14) provides that the term "disinterested person" means a person that:

(A) is not a creditor, an equity security holder, or an insider;
(B) is not and was not an investment banker for any outstanding security for the debtor;
(C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such investment banker in connection with the offer, sale, or issuance of a security of the debtor;
(D) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor or of an investment banker specified in subparagraph (B) or (C) of this paragraph; and
(E) 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

In relevant part, § 101(14) provides that a "disinterested person" means a person that: "(A) is not a creditor, an equity security holder, or an insider; . . . and (E) 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)(A), (E) (1994). Subsection (E), commonly referred to as the "catch-all clause," is broad enough to exclude an attorney with some interest or relationship that "would even faintly color the independence and impartial attitude required by the Code and the Rules." In re BH&P, Inc., 949 F.2d 1300, 1309 (3rd Cir. 1991); In re Black Hills Greyhound Racing Ass'n, 154 B.R. 285, 292 (Bankr. D.S.D. 1993).

When either of the tests for disinterestedness under § 327(a) is violated, a professional person is automatically disqualified from representing the estate. Pierce, 809 F.2d at 1362. "The purpose of § 327 is to prevent even the appearance of a conflict of interest, irrespective of the integrity of the person or firm under consideration." In re Nat'l Distributors

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> direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker specified in the subparagraph (B) or (C) of this paragraph, or for any other reason;

11 U.S.C. § 101(14) (1994).

Warehouse Co. Inc., 148 B.R. 558, 561 (Bankr. E.D. Ark. 1992). The requirements of § 327 "serve the important policy of ensuring that all professionals approved pursuant to section 327(a) tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities." Rome v. Braunstein, 19 F.3d 54, 57 (1st Cir. 1994), quoted in In re Guard Force Management, Inc., 185 B.R. 656, 661 (Bankr. D. Mass. 1995).

Obviously, § 327's conflict of interest provisions could not be enforced by the court without candid, up-front disclosure of potential conflicts by all applicants for employment. Accordingly, Bankruptcy Rule 2014 creates a disclosure requirement to enforce § 327's standard of disinterestedness. Rule 2014 provides, in relevant part:

> **(a) Application for and Order of Employment.** An order approving the employment of attorneys . . . or other professionals pursuant to § 327 . . . of the Code shall be made only on application of the trustee or committee. . . . The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, *and, to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest*, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. *The application 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 United States trustee, or any person employed in the office of the United States trustee.*

Fed. R. Bankr. P. 2014(a) (emphasis added). These disclosure requirements are not discretionary. In re EWC, Inc., 138 B.R. 276, 280 (Bankr. W.D. Okla. 1992). Even the negligent failure to disclose facts in an application will not relieve an attorney of the failure to disclose. Nat'l Distributors Warehouse, Co., 148 B.R. at 562-63.

Once a professional person complies with the disclosure requirements of Rule 2014 and satisfies the standards of § 327(a), the professional may be retained by court order. Sections 328, 330 and 331 of the Code then cover the issue of the professional's compensation. Pursuant to § 330 and Rule 2016(a), an employed professional must apply to the court for compensation and the court may award "reasonable compensation for actual, necessary services" and "reimbursement for actual, necessary expenses." FED. R. BANKR. P. 2016(a). Section 331 deals with the timing of such applications, allowing the professional to submit to the court an interim fee application once every 120 days after the order for relief.

As § 328(c) makes clear, however, the need for self-scrutiny and avoidance of conflicts does not end once the professional's employment application is approved. Section 328(c) provides that:

> Except as provided in section 327(c), 327(e), or 1107(b) of this title, the court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under section 327 or 1103 of this title if, at any time during such

> professional person's employment under section 327 or 1103 of this title, such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed.

11 U.S.C. § 328(c). Under § 328(c), the bankruptcy court has discretion to deny compensation and reimbursement to a conflicted professional. If it is determined that a professional employed by the estate was not disinterested or held or represented an interest adverse to the estate at any point during the course of the representation, the court may deny fees. Prince, 40 F.3d at 359; Merrimac Assoc., Inc. v. Daig Corp. (In re Daig Corp.), 799 F.2d 1251, 1253 (8th Cir. 1986). See also Woods v. City Nat'l Bank & Trust of Chicago, 312 U.S. 262, 269 (1941) ("Where an actual conflict of interest exists, no more need be shown in this type of case to support a denial of compensation"). Thus, absent the spontaneous, timely and complete disclosure required by § 327(a) and Rule 2014(a), court-appointed counsel proceed at their own risk. Rome, 19 F.3d at 59.

Finally, § 329 specifically subjects a debtor's attorney to additional scrutiny beyond that imposed by § 327. Section 329(a) provides:

> Any attorney representing a debtor in a case under this title, or in connection with such a case, whether or not such attorney applies for compensation under this title, shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the

> case by such attorney, and the source of such compensation.

11 U.S.C. § 329(a) (1994). The concern behind § 329 is that the debtor's attorney is not only in a peculiarly advantageous position to overreach, but also that the failing debtor may be tempted "to deal too liberally with his property in employing counsel to protect him in view of financial reverses and probable failure." In re Wood & Henderson, 210 U.S. 246, 253 (1908), quoted in FED. R. BANKR. P. 2017 Advisory Committee Note. Section 329(a) therefore requires a debtor's attorney to disclose to the court any compensation paid or promised to be paid for services performed in the case and the source of that payment, even if a non-debtor third party is paying the fees. Under Rule 2016(b), this disclosure must be made within 15 days of the order for relief. Furthermore, Rule 2016(b) requires the debtor's attorney to file a supplemental statement within 15 days after the attorney receives any previously undisclosed payment or makes a new agreement regarding compensation. These disclosure requirements apply whether or not the attorney applies for fees in the case.

Subsection (b) implements the teeth of § 329 by providing that "if such compensation exceeds the reasonable value of any such services the court may cancel any such agreement, or order the return of any such payment, to the extent excessive . . . ." 11 U.S.C. § 329(b) (1994). Thus, subsection (b) expressly authorizes the disgorgement of any excessive fees paid by the debtor to its attorney within one year before the date of the filing of the petition. In re DLIC, 120 B.R. 348, 350 (Bankr. S.D.N.Y. 1990); In re Western Office Partners, Ltd., 105 B.R. 631, 67 (Bankr. D. Cal. 1989). Because § 329 is aimed solely at preventing overreaching by a debtor's attorney, however, a court's consideration of whether to order disgorgement of fees under § 329(b) is limited to the comparison of the amount of compensation received by the attorney with the reasonable value of the services performed. See Creative Restaurant Management, Inc., 139 B.R. 902, 917 (Bankr. W.D. Mo. 1992); In re McDonald, 114 B.R. 964, 970-72 (W.D. Tex. 1992).

C. LARKIN'S MOTION FOR SUMMARY JUDGMENT

1. Disgorgement of Preconfirmation Attorneys' Fees

With respect to the preconfirmation fees, Larkin argues that, even assuming it was disqualified under § 327 from serving as Debtor's counsel, and even assuming there are grounds for revoking the order awarding Larkin its fees on a final basis,[7] this Court has no statutory authority to order the disgorgement

[7] Because of the procedural posture of this motion, the Court is not addressing and has not judged whether the Trustee's arguments are meritorious. A motion for summary judgment assumes the validity of the factual allegations of the non-moving party for purposes of the motion only. Thus, the only issue before me is a legal one: assuming that the Trustee is correct in asserting that Larkin was conflicted, whether or not the Court has any basis in law to order disgorgement.

of the $103,553.73 in allowed fees that Larkin has already been paid. Specifically, Larkin argues that the Bankruptcy Code authorizes the disgorgement of funds in only two specific provisions - in §§ 329 and 549. Larkin then argues that § 329(b) is unavailable in this case because the Trustee's motion does not assert that Larkin's fees were excessive in relation to the services performed. Moreover, Larkin further argues that, in contrast to Bankruptcy Rule 2017(a) (which authorizes motions to be made "by any party in interest"), Rule 2017(b) authorizes motions for disgorgement of postpetition fees to be made only by "the debtor, the United States trustee and on the court's own initiative," and does not authorize the Trustee to make such motions. As for § 549, Larkin asserts that its receipt of the preconfirmation fees was not an avoidable postpetition transfer because: 1) the payment of the preconfirmation fees was approved by the Court and therefore does not constitute the payment of property of the estate "that is not authorized under this title or by the court;" and 2) the two-year statute of limitations set out in § 549(d) has run. Finally, Larkin argues that, because §§ 329 and 549 each contain specific provisions providing for the disgorgement of funds, § 105 does not vest the Court with the equitable power to order disgorgement because § 105 does not allow the bankruptcy court to override the explicit provisions of other sections of the Bankruptcy Code.

For purposes of this motion only, Larkin concedes that it violated the disinterestedness standards of § 327. Even after assuming this to be true, however, Larkin is nonetheless correct in its argument that §§ 329 and 549 are inapplicable to this case. As discussed above, § 329 applies only to cases of overreaching or excessive fees. For purposes of Larkin's summary judgment motion, the Trustee does not assert or seek to establish that the fees Larkin received for services rendered after one year before the date of the commencement of the case were in any way excessive. Likewise, § 549 authorizes the Trustee to avoid *unauthorized* postpetition transfers of property of the estate, and Larkin's receipt of the preconfirmation fees in this case was approved by the order of this Court.

Instead, the applicable Code provision for purposes of analyzing this motion is § 328(c). Section 328(c) empowers the court to deny compensation and reimbursement to an employed professional person if it is discovered that the professional is not disinterested or represents or holds an interest adverse to the estate. Thus, § 328(c) is aimed squarely at penalizing those professionals who are employed by the estate, but who have violated the conflict of interest provisions of § 327 and Rule 2014. See S. REP. NO. 95-989, at 39 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5825. Although the complete denial of compensation and reimbursement of expenses after services have been performed may be "draconian and inherently unfair" under some circumstances, the sanction of denial of fees serves the important policy of "deter[ring] future wrongdoing by those punished and also to warn others who might consider similar defalcations." Gray v. English, 30 F.3d 1319, 1323 (10th Cir. 1994).

> The total denial of compensation that can result from strict application of this rule may appear unduly harsh in situations where the professional's services significantly benefited the estate. Such a windfall to the estate at the professional's expense might appear to violate the equitable principals upon which the bankruptcy law is based. On the other hand, the failure to penalize professionals who ignore the prior approval requirement could encourage evasion, thereby limiting the court's oversight role in the selection of professionals.

AMERICAN BANKRUPTCY INSTITUTE, NATIONAL REPORT ON PROFESSIONAL COMPENSATION IN BANKRUPTCY CASES 25 (1991).

Moreover, in the event that a conflict of interest is not discovered in time to deny the professional's compensation, it is within the court's power to order the disgorgement of any compensation already received. Prince, 40 F.3d at 360; Pierce, 809 F.2d at 1363; Lavender v. Wood Law Firm, 785 F.2d 247, 248 (8th Cir. 1986); Guard Force Management, 185 B.R. at 663; In re Profile Systems, Inc., No. 4-93-6080, slip op. at 17-18 (Bankr. D. Minn. 1994); In re Pappy's Foods Co., Inc., No. 3-91-6486, slip op. at 10 (Bankr. D. Minn. 1993); In re McNar, Inc., 116 B.R. 746, 750 (Bankr. S.D. Cal. 1990); In re Grabill, 113 B.R. 966, 975 (Bankr. N.D. Ill. 1990). See also Law Offices of Ivan W. Halperin v. Occidental Fin. Group, Inc. (In re Occidental Fin.

Group, Inc.), 40 F.3d 1059, 1063 (9th Cir. 1994); Gray, 30 F.2d at 1324-25. Therefore, in addition to authorizing the court to deny a conflicted professional's application for compensation, § 328(c) also allows the court to order the disgorgement of fees previously allowed by the court in the absence of full disclosure.

Larkin argues that the cases allowing the disgorgement of attorneys' fees under § 328(c) are loosely decided with little analysis of the legal underpinnings of the court's right to order disgorgement. Larkin asserts that, although § 328(c) authorizes a bankruptcy court to deny compensation to a conflicted professional, it does not authorize the court to order the disgorgement of fees already received pursuant to §§ 330 and 331. In response to this argument, the Trustee argues that: 1) bankruptcy courts possess the inherent power to order disgorgement of wrongfully received compensation; 2) bankruptcy courts possess the power to order disgorgement under 11 U.S.C. § 105; and 3) bankruptcy courts possess the power to order disgorgement under Fed. R. Bankr. P. 9024.

In the case of Chambers v. NASCO, Inc., 501 U.S. 32, 111 S.Ct. 2123 (1991), the United States Supreme Court held that the federal courts possess the inherent power to sanction bad-faith conduct that is abusive to the judicial process. Id. at 50, 2135-36. In so holding, the Chambers Court recognized that "certain implied powers must necessarily result to our Courts of justice from the nature of their institution, powers which cannot be dispensed with in a Court, because they are necessary to the exercise of all others." Id. at 43, 2132 (quoting United States v. Hudson, 7 Cranch 32, 34 (1812)). It is beyond question that the inherent power of the federal courts includes the power to vacate a judgment that has been obtained by fraud upon the court. Id. at 44, 2132; Universal Oil Prod. Co. v. Root Refining Co., 328 U.S. 575, 580, 66 S.Ct. 1176, 1179 (1946); Hazel-Atlas Glass Co. v. Hartford-Empire Co., 322 U.S. 238, 244, 64 S.Ct. 997, 1000 (1944). Furthermore, a federal court's inherent power includes "the power to control admission to its bar and to discipline attorneys who appear before it." Chambers, at 43, 2132 (citing Ex parte Burr, 9 Wheat. 529, 531 (1824)). Because inherent powers are shielded from direct democratic controls, they must be exercised with restraint and discretion. Id. at 44, 2132; Roadway Express, Inc. v. Piper, 447 U.S. 752, 764, 100 S.Ct. 2455, 2463 (1980).

When an attorney is employed by a trustee or a debtor in possession pursuant to § 327, the attorney represents the trustee or the debtor in possession not in an individual capacity, but rather as the representative of the bankruptcy estate. It necessarily follows that, as an attorney for the bankruptcy estate, a court-appointed attorney owes to the estate certain fiduciary duties, including the duty of utmost loyalty. As enforced by § 327(a) and Rule 2014(a), a court-appointed attorney's duty of loyalty to the estate enables creditors of the debtor to expect the attorney to utilize impartial and detached judgment and to make every reasonable effort to maximize the value of the bankruptcy estate. In this way, the strict adherence to the fiduciary duty of loyalty by attorneys employed by the estate is necessary to preserve the integrity and fairness of the bankruptcy process. Indeed, if an attorney were to represent a debtor's estate while simultaneously serving other interests, the quality of justice in an adversarial system would be compromised:

> The lawyer working under the burden of a conflict of interest does a disservice to his court and runs the risk even of subverting the justice system. If a lawyer holds himself out as representing one party, but in reality represents another, either in addition to or instead of his stated retainer, the lawyer distorts the judicial perspective.
>
> As officers of the court, lawyers frame issues and contend for results only as they might affect known interests. Judges direct their thinking and frame their decision along the lines presented them, the only lines they are allowed to know.

In re Chou-Chen Chemicals, Inc., 31 B.R. 842, 852 (Bankr. W.D. Ky 1983), quoted in Roberts, 46 B.R. at 838-39. Furthermore, because the bankruptcy court does not possess the resources to independently investigate an applicant's conflicts of interest, full and candid disclosure is required to enable the court to determine whether the applicant meets the "disinterested" standards of § 327(a). As a result, the bankruptcy court relies upon the candor and truthfulness of the applicant, as an officer of the court, when reviewing the applicant's Rule 2014(a) disclosure statement. Therefore, in light of the importance of full disclosure to the integrity and fairness of the bankruptcy process, the Court concludes that an attorney's intentional failure to disclose a conflict of interest in violation of § 327 and Rule 2014 amounts to fraud upon the bankruptcy court and an abuse of the judicial process. As such, an attorney's intentional failure to disclose conflicts constitutes sufficient grounds to exercise the inherent power of the Court to vacate the Court's previous orders allowing employment and compensation, as well as to order the disgorgement of any funds already received by the conflicted attorney.

From the language of the majority opinion in Chambers, it appears that the inherent power of the federal courts is vested in both Article III and non-Article III federal courts alike. Jones v. Bank of Santa Fe (In re Courtesy Inns, Ltd., Inc.), 40 F.3d 1084, 1089 (10th Cir. 1994). See 2 LAWRENCE P. KING ET AL., COLLIER ON BANKRUPTCY ¶ 105.04[1][a] (15th ed. rev. 1996). Even if this proposition is incorrect, however, it is certain that 11 U.S.C. § 105 provides the bankruptcy courts with broad general powers to effectuate the provisions of the Bankruptcy Code. Otoe County Nat'l Bank v. Easton (In re Easton), 882 F.2d 312, 315 (8th Cir. 1989). See also Bank of Marin v. England, 385 U.S. 99, 102-03, 87 S.Ct. 274, 277 (1966); Pepper v. Litton, 308 U.S. 295, 303-05, 60 S.Ct. 238, 244-45 (1939) (construing a parallel provision of the former Bankruptcy Act). Section 105(a) provides:

> The court may issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 105(a) (1994). Although the bankruptcy court's equitable powers are broad, § 105 does not give the courts unlimited authority to fashion relief as they deem appropriate. Instead, the court's § 105 powers must be exercised consistently with the provisions of the Bankruptcy Code. Easton, 882 F.2d at 315.

In this case, it is clear that § 328(c) does not expressly authorize the court to order the disgorgement of fees received by a conflicted attorney. It is equally clear, however, that the provisions of § 328(c) are meant to empower the court to prevent an attorney who fails the standards of § 327 from receiving compensation from the estate. Therefore, this Court concludes that the power to order conflicted professionals to disgorge wrongfully received compensation is necessary to effectuate the statutory objective of § 328(c). It follows from this that the power granted by 11 U.S.C. § 105 to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title" permits a bankruptcy court to order a conflicted attorney to disgorge previously allowed fees where the receipt of such fees was in violation of § 328(c) and where the court's order allowing the fees was made in absence of full disclosure.

Finally, Fed. R. Civ. P. 60(b) allows the Court to revoke its earlier orders and to order disgorgement. As incorporated by Bankruptcy Rule 9024, Rule 60(b) provides that, on motion and upon such terms as are just, a court may relieve a party or a party's legal representative from a final judgment, order or proceeding for any of six different reasons.[8] Because Rule 60(b)

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[8]Rule 60(b) provides, in relevant part:

> **(b) Mistakes; Inadvertence; Excusable Neglect; Newly Discovered Evidence; Fraud, etc.** On motion and upon such terms as are just, the court may relieve a party or a party's legal representative from a final judgment, order, or proceeding for the following reasons: (1) mistake, inadvertence surprise, or excusable neglect; (2) newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial under Rule 59(b); (3) fraud (whether heretofore denominated intrinsic or extrinsic), misrepresentation, or other misconduct of an adverse party; (4) the judgment is void; (5) the judgment has been satisfied, released, or discharged, or a prior judgment upon which it is based has been reversed or otherwise vacated, or it is no longer equitable that the judgment should have prospective application; or (6) any other reason justifying relief from the operation of a judgment. The motion shall be made within a reasonable time, and for reasons (1), (2) and (3) not more than one year after the judgment, order, or proceeding was entered or taken. A motion under this subdivision (b) does not affect the finality of a judgment or suspend its operation. This rule does not limit the power of a court to entertain an independent action to relieve a party from a judgment, order, or proceeding, or to grant relief to a defendant

provides that the court "may" relieve a party or a party's legal representative from a final judgment, order, or proceeding, the decision of whether to grant relief under Rule 60(b) is largely within the discretion of the trial court. 7 JAMES WM. MOORE, MOORE'S FEDERAL PRACTICE ¶ 60.19 (2d ed. 1996). In exercising this discretion, a court must balance the necessity of liberally construing Rule 60(b) so that final orders reflect the true merits of a case against the need for preserving the finality of judgments or orders. United States v. Poteet Constr. Co., Inc. (In re Poteet Constr. Co., Inc.), 122 B.R. 616, 618 (Bankr. S.D. Ga. 1990).

Subsections (1), (2) and (3) of Rule 60(b) allow a court to relieve a party from a final judgment, order or proceeding for the reasons of mistake or excusable neglect, newly discovered evidence, and fraud, respectively. At first glance, it appears

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> not actually personally notified as provided in Title 28, U.S.C., § 1655, or to set aside a judgment for fraud upon the court. Writs of coram nobis, coram vobis, audita querela, and bills of review and bills in the nature of a bill of review, are abolished, and the procedure for obtaining any relief from a judgment shall be by motion as prescribed in these rules or by an independent action.

FED. R. CIV. P. 60(b). Although Rule 60(b) does not limit the power of the Court "to entertain an independent action to relieve a party from a judgment, order, or proceeding," the Trustee has not commenced an independent action to vacate the Court's earlier orders authorizing employment and allowing compensation to the Larkin firm, and this provision is therefore inapplicable to this case.

that at least one of these provisions would constitute sufficient authority for the Court to vacate its earlier orders and to order the disgorgement of preconfirmation fees for purposes of this motion. As Larkin correctly points out, however, a motion for relief under Rule 60(b)(1)-(3) must be brought within one year following the entry of the court's final order, and relief under any of these provisions is therefore unavailable to the Trustee in this case.[9] As Larkin further points out, and as the Trustee concedes, the issue of fraud is not normally susceptible to determination on summary judgment grounds. Out of the remaining three alternatives, only Rule 60(b)(6) would have application to this case in its current procedural posture. Rule 60(b)(6) goes further than the other provisions of Rule 60(b), allowing a court to vacate an earlier judgment or order for "any other reason justifying relief from the operation of the judgment." The provisions of Rule 60(b)(1)-(6) are mutually exclusive, and thus a party may not resort to subsection (6) more than one year after the entry of the judgment or order merely because they failed to take timely action under Rule 60(b)(1)-(3). See Pioneer Inv. Servs. v. Brunswick Assoc., 113 S.Ct. 1489, 1497 (1993). To

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[9]The Court notes that, if it is ultimately decided that the Larkin firm has committed fraud by concealing its conflicts of interest, it is arguable that Rule 60(b)(3) would be applicable to this case because the doctrine of equitable tolling would act to toll the one-year limitations period until the time the fraud is actually discovered. See Holmberg v. Armbrecht, 327 U.S. 392, 396-98, 66 S.Ct. 582, 585 (1946); Moratzka v. Pomaville (In re Pomaville), 190 B.R. 632, 636-38 (Bankr. D. Minn. 1995).

justify relief under subsection (6), a party must either show some "other reason" justifying relief outside of the earlier clauses of the Rule, or, if the reasons for seeking relief could have been considered in an earlier motion under another subsection of the rule, they must show "extraordinary circumstances" suggesting the party is faultless in the delay. See id.; Doe v. Zimmerman (In re Zimmerman), 869 F.2d 1126 (8th Cir. 1989); 11 CHARLES ALLEN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 2864 (Civil 2d 1996). When the evidence of this case is viewed in the light most favorable to the Trustee, the Court concludes that the requirements of Rule 60(b)(6) have been satisfied for purposes of this motion. Because Larkin did not disclose the alleged conflict of interest to the Court, no party in interest had any knowledge of the conflict nor any realistic way of bringing a motion under Rule 60(b)(1)-(3) within the one-year limitations period. Therefore, the Court holds that the failure of an attorney employed by the estate to disclose a disqualifying conflict of interest, whether intentional or not, constitutes sufficient "extraordinary circumstances" to justify relief under Rule 60(b)(6). To hold otherwise would only serve to penalize the Trustee for delay that was beyond his control and to reward conflicted attorneys for failing to disclose their conflicts beyond the one-year period.

In summary, the Court concludes that, when the facts of this case are viewed in the light most favorable to the Trustee, there are three possible sources of authority upon which the Court may draw its power to order disgorgement of the preconfirmation fees: 1) the Court's inherent power; 2) the Court's power granted to it by 11 U.S.C. § 105; and 3) the Court's power under Rule 60(b)(6)[10] as incorporated by Bankruptcy Rule 9024. Accordingly, the Court finds that Larkin is not entitled to judgment as a matter of law and that Larkin's motion for summary judgment with respect to the preconfirmation fees must be denied.

2. DISGORGEMENT OF POSTCONFIRMATION ATTORNEYS' FEES

Larkin makes a different argument with respect to the fees paid to the Larkin firm for postconfirmation services pursuant to the August 5, 1992 confirmation order. Even if the confirmation order was procured by fraud, Larkin argues, § 1144 requires a request for the revocation of an order of confirmation to be made prior to 180 days following the date of the entry of the order. Larkin further argues that Bankruptcy Rule 9024 specifically provides that "a complaint to revoke an order confirming a plan may be filed only within the time allowed by § 1144 . . . ." Finally, Larkin argues that even if the court *could* revoke its confirmation order under § 1144 or Rule 9024, there is no demonstrated basis for doing so: Larkin performed

[10] As earlier indicated, Rule 60(b)(3) might also be available if equitable tolling of the one-year statute of limitations applied and fraud were found.

postconfirmation services which, according to the Code, are not restricted by the provisions of §§ 327-331 and the Trustee has made no argument that Larkins' postconfirmation services were in any way excessive for the services provided.

Larkin's reliance on § 1144 mischaracterizes the issue in this case, however. Section 1144 describes the circumstances under which a court may revoke an order of confirmation. The Trustee has not requested the Court to *revoke* its earlier confirmation order, but has instead asked the Court to *modify* the terms of the confirmed plan that deal with Larkin's provision of postconfirmation services. Thus, as a request for the modification of a confirmed plan, the Trustee's motion does not implicate § 1144, and is properly analyzed solely under Fed. R. Civ. P. 60(b)(6), as incorporated by Fed. R. Bankr. P. 9024.[11]

It is true that, under the appropriate circumstances, Rule 60(b) is a vehicle for affording relief to a party from the res judicata effect of a court's order of confirmation. Poteet Constr. Co., Inc., 122 B.R. at 618. Nevertheless, the Court holds that, as a matter of law, this is not an appropriate case for applying Rule 60(b)(6) to modify the terms of the confirmation order. Although the Court has the power under Rule

[11]As stated above, motions for relief under Rule 60(b)(1),(2), or (3) must be brought within one year following the entry of the court's final order, and, unless such limitations are tolled, relief under any of these provisions is therefore unavailable to the Trustee. Moreover, neither Rule 60(b)(4) nor (b)(5) has any application to this case.

60(b)(6) to modify the terms of a confirmed plan, the Trustee has failed to demonstrate adequate legal grounds for the Court to do so. Sections 327 and 328 apply only to professionals employed by *a trustee or debtor in possession*, and are therefore inapplicable to conflicts occurring either prior to the order for relief or postconfirmation. See In re Wiredyne, 3 F.3d 1125, 1127 (7th Cir. 1993); McNar, 116 B.R. at 753-54; Grabill, 113 B.R. at 975. Once confirmation occurs in a Chapter 11 case, § 1141 vests all property of the estate in the debtor, and the debtor is then free, if the debtor so chooses, to retain professionals that would otherwise be disqualified under § 327. Therefore, although §§ 327 and 328 of the Code regulate a professional's employment and compensation for *preconfirmation* services, they do not apply to a debtor's employment of professionals *postconfirmation*. The sole reason for the Trustee's motion to disgorge in this case is Larkin's alleged violation of the conflict of interest standards of § 327(a). Although such a violation is sufficient to prevent a professional from receiving compensation for preconfirmation services provided to the estate, the Court does not believe that, by itself, a violation of § 327(a) constitutes sufficient "exceptional or extraordinary circumstances" to justify the upset of the Court's confirmation order under Rule 60(b)(6). Finally, the Trustee has other means of attempting to recover such fees. For example, if Larkin committed malpractice in the course of Larkin's postconfirmation representation of the Debtor, as the

Trustee claims, the Trustee will be able to recover for such in the pending adversary proceeding.

ACCORDINGLY, IT IS HEREBY ORDERED THAT:

1. The motion of Larkin, Hoffman, Daly and Lindgren, P.A. for partial summary judgment with respect to the postpetition/preconfirmation fees is DENIED.

2. The motion of Larkin, Hoffman, Daly and Lindgren, P.A. for partial summary judgment with respect to the postpetition/postconfirmation fees is GRANTED.

Nancy C. Dreher
United States Bankruptcy Judge