

UNITED STATES BANKRUPTCY COURT
DISTRICT OF SOUTH DAKOTA
Central Division

In re:) Bankr. No. 99-30061
)
THOMAS ZANE REEVES)
a/k/a Tom Reeves) INTERIM DECISION RE:
Soc. Sec. No. [REDACTED]-2028) FEE APPLICATION
) BY ATTORNEY HURLEY
Debtor.)

The matter before the Court is the application for final compensation and costs and two supplements filed by Debtor's former attorney, James P. Hurley. This Interim Decision shall constitute the Court's preliminary findings and conclusions under Fed.R.Bankr.P. 7052. As set forth below, the Court concludes that the application to employ Attorney Hurley and his affidavit as the professional to be employed failed to disclose a disqualifying conflict of interest and that some or all bankruptcy-related fees to Attorney Hurley may be disgorged or disallowed.

I.

Due to financial problems, Thomas Z. Reeves ("Tom Reeves") and his wife Carmen consulted Attorney James P. Hurley for help in working with the couple's creditors. A brief contact was made in late February 1999. More substantial services were rendered by Attorney Hurley beginning in mid-April 1999. At the time, Attorney Hurley was also serving as counsel for Tom Reeve's parents Arthur Dean ("Dean") and Emma Lou Reeves, his brother Jimmy Dean, and his sister Mary. By mid-May 1999, Tom and Carmen Reeves contemplated

90

filing a Chapter 12 petition. By that time, Tom's parents and brother had already filed Chapter 12 petitions. Their respective Chapter 12 plans were confirmed August 4, 1999. Tom Reeves filed a Chapter 12 petition on August 11, 1999 (his wife did not file).

In his schedule of unsecured creditors, Tom Reeves listed his father Dean Reeves as holding a claim for \$64,071 for livestock care in 1998. In his statement of financial affairs, Tom Reeves stated that he paid Attorney Hurley \$5,000 for debt counseling or bankruptcy on December 24, 1998. In his Disclosure of Compensation, Attorney Hurley acknowledged receipt of a \$5,000 retainer and stated that it was paid by Tom Reeves.

In his application to employ Attorney Hurley as his bankruptcy counsel, Tom Reeves stated that he did not know of any connections that Attorney Hurley had to any of his creditors or another party in interest. Attorney Hurley's accompanying affidavit as the professional to be employed acknowledged that Tom Reeves

is the son of Dean and Emma Lu Reeves, and the brother of Jim Reeves. [My law firm] is representing Dean and Emma Lu Reeves in Chapter 12 Case No. 99-30008, and is representing Jim Reeves in Chapter 12 Case No. 99-30009. The Plans have been confirmed in both cases. [Tom Reeves] owns cattle and horses that are pastured, fed, and cared for on the Dean Reeves Family Ranch. [Tom Reeves], Jim Reeves, Dean Reeves, and Emma Lu Reeves, each owe obligations to the Bank of Hoven, which holds liens on their livestock and other personal property and a mortgage on real estate owned by Emma Lu Reeves.

He did not disclose in his affidavit that Tom Reeves owed \$64,071 to his father.

An evidentiary hearing on a cash collateral motion by Tom Reeves and an objection to exemptions and a turnover motion by the Bank of Hoven was scheduled for December 22, 1999. Just one day before the hearing, the Bank of Hoven moved for the removal of Attorney Hurley as Tom Reeves' bankruptcy attorney due to Attorney Hurley's concurrent representation of Dean Reeves, one of Tom Reeves' creditors. A telephonic hearing was held and the Bank's request was granted. The December 22, 1999 hearings were rescheduled to a later date so that Tom Reeves could find replacement counsel. With the Court's consent, during and immediately following the December 21, 1999 telephonic hearing, the parties reached a preliminary cash collateral agreement to serve in the interim. The Court also directed Tom Reeves to turn over to the Bank certain livestock sale proceeds. Tom Reeves did not obtain new bankruptcy counsel. He eventually worked out a settlement with the Bank of Hoven and he voluntarily dismissed his case on February 4, 2000.

Attorney Hurley filed a final application for compensation of services and reimbursement of expenses. Therein, Attorney Hurley itemized services from August 17, 1999, which was a few days after Tom Reeves filed bankruptcy, through January 17, 2000, when Attorney Hurley reviewed proposed orders related to the matters addressed at the December 21, 1999 telephonic hearing. His time expended totaled 67.50 hours for which he sought \$8,437.50 in

compensation. Attorney Hurley also sought sale tax on services of \$506.25 and reimbursement for related expenses of \$455.93. Attorney Hurley's application also disclosed that Tom Reeves' account carried a previous balance of \$2,610.44. Thus, the total fees and costs sought was \$12,010.12.

Tom Reeves filed a late objection to Attorney Hurley's final fee application. He stated that he had not received any benefit from Attorney Hurley's services since Attorney Hurley was unable to bring the case to a conclusion. He also acknowledged Attorney Hurley's conflict of interest arising from his concurrent representation of an estate creditor.

After reviewing Attorney Hurley's fee application and Tom Reeves' objection, the Court directed Attorney Hurley to respond to Tom Reeves' objection, explain the services that represented the \$2,610.44 previous balance, explain why services for his initial conferences with Tom Reeves and preparing the petition and schedules were not included in the itemization of services, and set forth his arguments regarding why he should be compensated when he had not clearly disclosed (in his affidavit of a professional to be employed) his representation of creditor Dean Reeves.

In the supplement, Attorney Hurley stated that Dean Reeves' claim was fully disclosed on Tom Reeves' schedules. He also said that livestock sale proceeds that Tom Reeves held on the petition date (the collateral of the Bank of Hoven) were sufficient to pay

Dean Reeves' claim. As to his being a creditor of Tom Reeves' on the petition date due to the balance due on the petition date, Attorney Hurley stated that his \$5,000 pre-petition retainer covered these pre-petition legal services (and apparently left a credit balance of \$2,389.56 on the petition date). He also disputed Tom Reeves' contention that Tom had not benefitted from his legal services.

Finally, in his supplement, Attorney Hurley stated that Tom Reeves' parents had said that they would not insist on being paid for the 1998 cattle care if Tom could not raise the funds. The date this debt was forgiven or compromised was not disclosed. In Dean and Emma Lu Reeves' case, their claim against Tom Reeves was not scheduled as an account receivable, any forgiveness or other disposition of this account receivable was not mentioned, and the claim against Tom Reeves was not valued in the liquidation analysis attached to their plan.

After reviewing Attorney Hurley's supplement, the Court requested an itemization of the services and expenses incurred pre-petition for Tom and Carmen Reeves. Attorney Hurley filed this second supplement and therein described the services rendered and the time expended on Tom and Carmen Reeves' file from February 24, 1999 through August 3, 1999. He stated he rendered 19.55 hours of service for \$2,443.75 and that he incurred sales tax on services of \$146.63 and expenses of \$20.06, for a total of \$2,610.44. The

record does not contain an explanation why a retainer was paid to Attorney Hurley on December 24, 1998 when legal services were not rendered by him until February 1999.

II.
FAILURE TO DISCLOSE.

A Chapter 12 debtor-in-possession must obtain court approval to hire an attorney to act as their bankruptcy counsel. 11 U.S.C. §§ 327, 1106(a), and 1203. Section 327 provides:

(a) Except as otherwise provided in this section, the [debtor-in-possession], with the court's approval, may employ one or more attorneys . . . that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the [debtor-in-possession] in carrying out the [debtor-in-possession]'s duties under this title.

. . .

(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.

. . .

The statute presents two key requirements. The attorney may not hold an interest adverse to the estate and the attorney must be disinterested.

An adverse interest exists when two or more entities possess or assert mutually exclusive claims to the same economic interest. *In re Black Hills Greyhound Racing Association*, 154 B.R. 285, 292 (Bankr. D.S.D. 1993) (citing *In re National Distributors Warehouse Co.*, 148 B.R. 558, 560-61 (Bankr. E.D. Ark. 1992) (cite therein)).

To represent an adverse interest includes serving as an attorney for an individual or entity that holds an adverse claim. *Black Hills Greyhound Racing*, 154 B.R. at 285 (citing *National Distributors Warehouse*, 148 B.R. at 561).

A "disinterested person," as defined by § 101(14) of the Code, includes one who:

(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[.]

The catch-all clause (E) is broad enough to exclude anyone with some interest or relationship that would even faintly color the independence and impartial attitude required by the Code and Rules. *Black Hills Greyhound Racing*, 154 B.R. at 292 (citing *In re BH & P, Inc.*, 949 F.2d 1300, 1309 (3rd Cir. 1991)) (cited in *Kravit, Gass & Weber S.C. v. Michel (In re Crivello)*, 134 F.3d 831, 835 (7th Cir. 1998)). However, a Chapter 12 debtor in possession may employ an attorney who was employed by a creditor, unless there is an actual conflict of interest to which an objection has been raised. 11 U.S.C. § 327(c).

To insure compliance with § 327, Fed.R.Bankr.P. 2014(a) requires substantial disclosure when a debtor-in-possession files an application to employ an attorney. Compliance with these disclosure requirements protects the integrity of the bankruptcy

process. *In re Remmen*, 222 B.R. 623, 626 (Bankr. D. Neb. 1998). "When a professional is not disinterested, it gives an impression of impropriety and undercuts the integrity of the bankruptcy process." *Id.*

Under Rule 2014(a), an application by a debtor-in-possession to employ an attorney is required to include, among other things, "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 [emphasis added].*" Rule 2014(a) also requires the employment application to 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 [emphasis added].*"

The disclosures in the employment application and the affidavit should be complete in and of themselves. The court should not have to "ferret out pertinent information from other sources." *In re Independent Engineering Co.*, 232 B.R. 529, 531-32

(B.A.P. 1st Cir. 1999) (quoted in *In re Keller Financial Services of Florida, Inc.*, 248 B.R. 859, 883 (Bankr. M.D. Fla. 2000)); accord *Black Hills Greyhound Racing*, 154 B.R. at 295-96; *Winship v. Cook (In re Cook)*, 223 B.R. 782, 793 (B.A.P. 10th Cir. 1998). Moreover, the decision about what information to disclose is not left to the attorney "whose judgment may be clouded by the benefits of the potential employment." *In re Rusty Jones, Inc.*, 134 B.R. 321, 345 (Bankr. N.D. Ill. 1991) (quoting *In re Lee*, 94 B.R. 172, 176 (Bankr. C.D. Cal. 1989)); accord *In re Perry*, 194 B.R. 875, 879 (Bankr. E.D. Cal. 1996); *In re Diamond Mortgage Corp. of Illinois*, 135 B.R. 78, 97 (Bankr. N.D. Ill. 1990). As this Court noted,

The purpose of the disclosure is to let the court and interested parties determine whether that attorney can fulfill the fiduciary obligation that is owed not only to the debtor but also to the entire estate, including creditors. *Wolf v. Weinstein*, 372 U.S. 633, 83 S.Ct. 969, 10 L.Ed.2d 33 (1963) (cited in *United Utensils Corp.*, 141 B.R. at 309). The requirements of § 327(a) must be met "irrespective of the integrity of the person or firm under consideration."

Black Hills Greyhound Racing Association, 154 B.R. at 295 (quoting *National Distributors Warehouse*, 148 B.R. at 561); accord *Neben v. Starrett, Inc. v. Chartwell Financial Corp. (In re Park-Helena Corp.)*, 63 F.3d 877, 880-81 (9th Cir. 1995). Further, an actual or potential conflict cannot be waived. *Perry*, 194 B.R. at 880-81.

Informed consent [cannot] be obtained because . . . 'the real parties in interest are the creditors, and that is not a waivable conflict.'

Id. at 880 (quoting lower court).

If the attorney to be employed fails to disclose a relationship that presents a potential area of conflict, compensation to that attorney may be denied. 11 U.S.C. § 328(c); *Crivello*, 134 F.3d at 837; *Pierce v. Aetna Life Ins. Co. (In re Pierce)*, 809 F.2d 1356, 1363 (8th Cir. 1987); *Pruss v. Pelofsky (In re Sauer)*, 222 B.R. 604, 608-09 (B.A.P. 8th Cir. 1998). An attorney who signs an affidavit under Rule 2014(a) that does not disclose potential conflicts of interest may also face sanctions under Fed.R.Bankr.P. 9011. *Pierce*, 809 F.2d at 1363 n.21; *Snyder v. Dewoskin (In re Mahendra)*, 131 F.3d 750, 758-59 (8th Cir. 1997). Further, an inquiry into the reasonableness of fees under 11 U.S.C. § 329(b) may also encompass whether the debtor's attorney represented an adverse interest. "'[R]easonable compensation for services' necessarily implies loyal and disinterested service in the interest of those for whom the claimant purported to act." *Woods v. City National Bank & Trust Co.*, 312 U.S. 262, 268 (1941) (discussing the effect of an ethical violation upon the reasonableness of a fee in the bankruptcy context) (quoted in *In re Martin*, 197 B.R. 120, 128 (Bankr. D. Colo. 1996)). Damage to the

bankruptcy estate is not required for compensation to be reduced or denied; compensation may be denied regardless of whether the undisclosed connection is material or has *de minimis* impact. *Perry*, 196 B.R. at 881.

Whether to disallow or disgorge fees when an inadequate disclosure has been made is left to the court's discretion. *Crivello*, 134 F.3d at 836-39; *Sauer*, 222 B.R. at 609 (cites therein). The harsh sanction of disallowance or disgorgement must be weighed against the realities of the case, *In re Marolf Dakota Farms Cheese, Inc.*, Bankr. No. 89-50045, 1990 WL 495459 (Bankr. D.S.D. Oct. 17, 1990) (cite therein); see *Remmen*, 222 B.R. at 626, as well as the equities of the case. *Crivello*, 134 F.3d at 838. The court may consider the circumstances and motivations surrounding the failure to disclose. *Sauer*, 222 B.R. at 609-10. While even a negligent or inadvertent failure to disclose relevant information may result in a denial of all fees, willful or egregious violations more surely will. *Park-Helena Corp.*, 63 F.3d at 881-82 (cites therein); *Electro-wire Products, Inc. v. Sirote & Permutt, P.C. (In re Prince)*, 40 F.3d 356, 360-61 (11th Cir. 1994); *Keller Financial Services*, 248 B.R. at 877-907.

III.
DISCUSSION.

For two reasons, the Court concludes that some or all bankruptcy-related fees for Attorney Hurley must be disgorged or

disallowed in this case. First, the application to employ Attorney Hurley and his accompanying affidavit did not disclose that Debtor Tom Reeves owed money to Dean Reeves, another client of Attorney Hurley's. This information was clearly required to be disclosed under Rule 2014(a), *Pierce*, 809 F.2d at 1363, and Attorney Hurley was fully aware of his representation of Dean Reeves when Tom Reeves filed his petition and the application to employ. The Court and United States Trustee should not have had to glean this information from Tom Reeves' schedules. *Black Hills Greyhound Racing*, 154 B.R. at 295-96. Whether Debtor Tom Reeves and the creditor, his father, consented to this concurrent representation is not material. *Perry*, 194 B.R. at 879-81; *Black Hills Greyhound Racing*, 154 B.R. at 294. Moreover, Attorney Hurley could not unilaterally assess whether a potential conflict existed and needed to be disclosed; all connections are required to be disclosed. *Black Hills Greyhound Racing*, 154 B.R. at 292-93 (cites therein).

The second reason a disallowance of all or some bankruptcy related fees is appropriate in this case is because this is not the first time Attorney Hurley, an experienced bankruptcy practitioner, has had an actual conflict of interest when representing a debtor and this is not the first time that the Court has brought the matter to his attention. See *Remmen*, 222 B.R. at 626. In addition to the requirements set forth in the Bankruptcy Code and federal

rules, Attorney Hurley received direct notice of the consequences of undisclosed conflicts in *Marolf Dakota Farms Cheese*, 1990 WL 495459, in which he was the debtor's counsel. He also received general notice through the published decision *Black Hills Greyhound Racing*, 154 B.R. 285, where all fees to the debtor's counsel were disallowed. There have also been other recent decisions in this District on the same or related subjects. See *In re Kirwan Ranch*, Bankr. No. 97-30004, letter op. (Bankr. D.S.D. July 14, 2000) (fees were not disgorged since they would not be repaid to the estate), and *In re Swenson*, Bankr. No. 99-10195, slip op. (Bankr. D.S.D. May 4, 2000) (disclosure problem only). One recent case involved Attorney Hurley, again as the debtors' counsel. In *In re Outka*, Bankr. No. 97-50491, slip op. (Bankr. D.S.D. April 13, 2000), there was an inadequate disclosure of a pre-petition fee arrangement that involved an estate creditor, who was also an insider. *Id.* The Court did not disgorge fees from Attorney Hurley since the facts were a bit different than those presented in either *Marolf Dakota Farms Cheese* or *Black Hills Greyhound Racing*. *Id.* In contrast, the fact situation in this case reflects a similar failure to disclosure as was discussed in both *Marolf Dakota Farms Cheese* and *Black Hills Greyhound Racing*.

This case is a cardinal example of the importance of the strict standards of disclosure, which are unique to bankruptcy.

See *Rome v. Braunstein*, 19 F.3d 54, 57-58 (5th Cir. 1994) (cite therein). If Attorney Hurley had disclosed in the employment application and affidavit that he was currently representing one of Tom Reeves' major unsecured creditors, the United States Trustee or another party in interest would have had a more timely opportunity to review the situation for an actual, disqualifying conflict of interest as provided by § 327(c). Instead, there was substantial activity in the case before the matter came to light. The delay in disclosure and ultimate disqualification of Attorney Hurley was inopportune for Debtor Tom Reeves, creditors, and the Court alike.

This case is also a prime example why conflicts of interest must be scrupulously avoided in bankruptcy cases. If the best interests of Dean and Emma Lu Reeves' bankruptcy estate had been fostered and if Dean and Emma Lu Reeves had acted in a fiduciary capacity for their creditors, then efforts would have been made to collect the full \$64,071 from Tom Reeves. *In re Erickson*, 183 B.R. 189, 193-94 (Bankr. D. Minn. 1995) (a Chapter 12 debtor-in-possession is legally charged "with acting to preserve and enhance the estate's value so creditors' returns will be maximized") (cites therein); accord *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 471-72 (3rd Cir. 1998); *Badami v. K.E. Joy, P.C. (In re Joy)*, 175 B.R. 303, 305 (Bankr. D. Neb. 1994) (Chapter 11 debtor in possession had fiduciary obligation to seek payment of claims from his closely held corporation). Had this account receivable been

collected by their bankruptcy estate, unsecured creditors may have been paid more on their claims or, if this account receivable was secured to the Bank of Hoven, the Bank's secured claim may have been increased by \$64,071. In contrast, if the best interests of Tom Reeves' bankruptcy estate had been fostered and if Tom Reeves had acted in a fiduciary capacity for his creditors, then his efforts would have been directed at insuring the claim held by his father was valid and in trying to work a compromise, if possible. Though it is unclear what actually happened, it appears that Tom Reeves and his creditors, so far, have gotten the better deal and that Dean and Emma Lu Reeves' creditors have been shortchanged by \$64,071.

Disallowing or disgorging fees for an estate professional, whether due to a conflict of interest or another problem, is a distasteful task. However, it is the means provided to the Court by the Bankruptcy Code and Federal Rules to reinforce the importance of full disclosure to insure that attorneys for debtors-in-possession remain free from biases that may color their representation.

The present record indicates Attorney Hurley was already serving as counsel for Tom and Carmen Reeves, who then owed Dean and Emma Lu the \$64,071, when Attorney Hurley was employed by Dean and Emma Lu Reeves' bankruptcy estate. Accordingly, a review of Attorney Hurley's fees under § 327(c) or § 329(b) is necessary in

that case, also. Notice to Attorney Hurley and an opportunity for hearing will be given in that case, Bankr. No. 99-30008. The Court will then decide whether any fees should be disgorged in that case and the Court will then decide the amount of fees that should be disgorged or disallowed in this case.

Dated this 14 day of August, 2000.

BY THE COURT:



Irvin N. Hoyt
Bankruptcy Judge

NOTICE OF ENTRY
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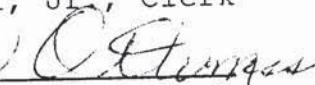
AUG 14 2000

Charles L. Nail, Jr., Clerk
U.S. Bankruptcy Court
District of South Dakota



(SEAL)

Charles L. Nail, Jr., Clerk


Deputy Clerk

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AUG 14 2000

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U.S. Bankruptcy Court, District of South Dakota
By AC

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