212

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF UTAH

CENTRAL DIVISION

In Re:

AMERICAN TIERRA, INC.,

Debtor.

CLARK W. SESSIONS, SESSIONS & MOORE,

Appellant,

-vs-

AMERICAN TIERRA, INC.,

Appellee.

MEMORANDUM DECISION AND ORDER

Civil No. C-85-0107W
Bankruptcy No. 81-03073

This matter is before the court on appeal from the bankruptcy court. Appellant, Sessions & Moore, claims that the bankruptcy court erred in denying Sessions & Moore's application for compensation for services rendered on behalf of the debtor, American Tierra, Inc. (hereinafter referred to as either "American Tierra" or the "debtor"), in the above-captioned case. A hearing was held on February 27, 1986. Clark Sessions appeared on behalf of the appellant. At the conclusion of the hearing, the court took the matter under advisement. The court has reviewed and considered carefully the appellant's oral arguments and brief, including various authorities cited therein and additional authorities, and the entire record on appeal. Now being fully advised, the court renders the following memorandum decision and order.

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Statement of the Case

On October 9, 1981, American Tierra filed a petition for relief under Chapter 11 of Title 11, United States Code.

On or about November 13, 1981, Roy B. Moore and Robert C. Woodcock of Sessions & Moore each filed an Affidavit of Proposed Attorney. The affidavits stated that the attorneys had no connection with the debtor, its creditors, or any other party in interest and that the attorneys did not represent any interest adverse to the debtor or its estate. As exceptions to the foregoing representations, the affidavits disclosed certain potential conflicts of interest: (1) that Sessions & Moore had represented the debtor in numerous legal matters for at least three years prior to the filing of the bankruptcy petition; (2) that Roy Moore was a shareholder, director, and officer[1] of Western Heritage Thrift & Loan Co. ("Western Heritage"), a creditor in the pending bankruptcy; and (3) that Sessions & Moore had previously represented Western Heritage and Surety Life Insurance Company ("Surety Life"), both creditors of the debtor, on numerous occasions.

Western Heritage and Surety Life were notified of

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[1] Sessions & Moore's brief indicates that Roy Moore was never an officer of Western Heritage or at least not an officer during his representation of the debtor in the bankruptcy proceeding. (Brief at 20-21).

Sessions & Moore's intention to represent the debtor in the bankruptcy proceedings, and they acquiesced in the arrangement. Sessions & Moore represented to the court that it would not represent either Western Heritage or Surety Life in any matter directly or indirectly related to the debtor's bankruptcy. From the outset, Western Heritage and Surety Life were both represented by independent counsel.

At the insistence of Sessions & Moore and because of potential conflicts of interest between the debtor and Sessions & Moore, the debtor sought to retain William T. Thurman, Jr., as an independent co-counsel.

By Order dated November 24, 1981, the bankruptcy court approved the employment of Roy B. Moore, Robert C. Woodcock, and William T. Thurman, Jr., as attorneys for the debtor. These attorneys represented the debtor in various bankruptcy matters until sometime in the summer of 1982.

On May 10, 1982, Sessions & Moore filed an Application for Compensation for Services rendered, seeking approval of compensation for the services that they performed for the debtor. The Creditors' Committee objected to the fee application because of Roy Moore's connections with Western Heritage and other creditors of the debtor, because of discrepancies in time entries in the application and allocation of fees, and because the debtor had paid Roy Moore a finder's fee for certain services performed

prior to the bankruptcy by conveying to him a parcel of real property.

Subsequently, Sessions & Moore filed an Amended Application for Compensation for Legal Services Rendered and Supplemental Affidavit of Attorney in Support Thereof, clarifying the discrepancies in the time entries and the fee allocation problems, addressing the conflicts of interest alleged by the Creditors' Committee, and correcting Sessions & Moore's initial Statement of Attorney with regard to the amount listed as having been paid or promised by the debtor prior to the petition date for bankruptcy-related work.[2]

By Order dated August 9, 1982, the bankruptcy court found and concluded that Roy Moore was not a disinterested person within the meaning of 11 U.S.C. § 101(13) since he had interests materially adverse to the interests of the estate or of one or more classes of creditors. Therefore, pursuant to 11 U.S.C.

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2 Apparently, the initial Statement of Attorney for Debtor, filed on October 9, 1981, erroneously listed $37,853.41 as the amount paid or promised prepetition to Sessions & Moore by the debtor for work related to the bankruptcy. Sessions & Moore stated in its amended fee application that the $37,853.41 figure was meant to represent fees and costs paid or promised to Sessions & Moore by the debtor prior and unrelated to the filing of the bankruptcy petition. According to Sessions & Moore, at the time it filed the amended fee application, the amount paid by the debtor for legal fees and costs incurred incident to the bankruptcy totalled $6,271.75 and was paid for an advanced retainer of $10,551.44 deposited with Sessions & Moore before the filing of the petition.

§ 328(c), the court denied Sessions & Moore's application for fees in its entirety and disqualified Sessions & Moore as attorneys for the debtor.

Sessions & Moore moved the bankruptcy court to reconsider its ruling. At a hearing on June 8, 1983, the bankruptcy court again denied the compensation sought, finding (1) that Sessions & Moore had not disclosed that Roy Moore was a shareholder and director of A.I.D. Financial Corp. ("AID Financial"), the parent of Western Heritage and (according to the court) a creditor of the debtor; (2) that Sessions & Moore had not disclosed the prepetition conveyance of Lot 61, Prospector Hills No. 8 subdivision, to Roy Moore at a time when he may have been an insider; (3) that Sessions & Moore had not disclosed a creditor-debtor relationship between Western Heritage and Empire Development Corp. ("Empire Development"),[3] and certain transactions involving Western Heritage, Empire, and the debtor, whereby Western Heritage obtained security interests that may have been subject to attack by the debtor;[4] (4) that Sessions & Moore had not disclosed its representations of Charles Moore in

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3 Apparently, Empire was controlled by Charles Moore, who was also a principal of the debtor.

4 According to the bankruptcy court, the transactions called into question the validity of certain security interests claimed by Western Heritage in lots owned by the debtor and/or lots that may have been transferred improperly.

certain non-bankruptcy court proceedings; and (5) that Sessions & Moore had failed to explain the $37,853.41 initially listed as the amount paid prior to the filing of the bankruptcy petition for services rendered in connection with the bankruptcy.[5] The court noted also that there were allegations that transactions involving the debtor, South Village, Inc. ("South Village"),[6] and General Electric Credit Corp. ("General Electric") may have triggered an invalid security interest in favor of Western Heritage in property owned by the debtor.[7]

Sessions & Moore contends that the bankruptcy court erred in denying Sessions & Moore's application for compensation for services rendered on behalf of the debtor. However, based on a thorough de novo review of the record before it, this court is of the opinion that Sessions & Moore failed to fully disclose all potential conflicts of interest and that the bankruptcy court did not err in denying Sessions & Moore's fee application in its entirety and disqualifying Sessions & Moore as counsel for the debtor.

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5 This court does not give weight to this basis of the bankruptcy court's denial of fees.

6 According to the court, Roy Moore also represented South Village at the time of the alleged transactions.

7 These transactions may be connected to or the same as the previously mentioned transactions which may have been subject to attack by the debtor.

Discussion

11 U.S.C. § 328(c) permits a bankruptcy court, in its discretion, to deny compensation for services rendered by an attorney for the debtor if the attorney is not disinterested[8] or if he represents or holds an interest adverse to the estate's interest. Section 328(c) therefore provides a heavy penalty for conflicts of interest and specifically provides:

> 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.

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8 According to 11 U.S.C. § 101(13)(E) (emphasis added), a "disinterested person" is a person that "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." This subsection is "broad enough to include anyone who in the slightest degree might have some interest or relationship that would color the independent and impartial attitude required by the Code." 2 Collier on Bankruptcy ¶ 327.03[3][f] at 327-19 (15th ed. 1986). Indirect or remote associations or affiliations, as well as direct ones, may engender conflicting loyalties. The purpose of the rule is to prevent the emergence of a conflict irrespective of the integrity of the person under consideration. Even the appearance of a conflict of interest must be avoided.

The object of § 328(c) is to ensure that a professional person, such as an attorney for the debtor, does not have any interest concerning matters of the debtor's estate which might, in the view of the bankruptcy court, affect the performance of his services or impair the high degree of impartiality and detached judgment expected of him during the administration of the case. One policy behind the § 328(c) fee penalty is "to preclude the honest practitioner from putting himself in a position where he may be required to choose between conflicting duties . . . . In other words, the penalty serves a prophylactic purpose. It strikes not only at actual evil, but at the tendency of divided loyalty to create evil." Barton v. Chrysler (In re Paine), 14 Bankr. 272, 274-75 (W.D. Mich. 1981). Indeed, experience has shown that conflicts of interest tend to delay action where speed is essential, to close the record of past transactions where publicity and investigation are needed, to compromise claims by inattention where vigilant assertion is necessary, or otherwise to dilute the undivided loyalty owed to those whom the attorney purports to represent. Accord Woods v. City National Bank and Trust Co., 312 U.S. 262, 268 (1941). Consequently, the substance of § 328(c) cannot be circumvented by agreement or consent among interested parties. See 2 Collier on Bankruptcy ¶ 328.04 (15th ed. 1986). And it is incumbent upon the attorney at the outset to disclose to the bankruptcy court any material fact which may

relate to potential conflicts of interest.[9]

As § 328(c) indicates, the bankruptcy court's discretion in denying compensation for conflicts of interest is limited by certain exceptions. 11 U.S.C. § 327(c) is one of those exceptions; and prior to the 1984 amendments to the Bankruptcy Code,[10] § 327(c) provided: "In a case under chapter 7 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, but may not, while employed by the trustee, represent, in connection with the case, a creditor."

Section 327(c) makes it clear that Sessions & Moore would not have been disqualified from employment as counsel for the debtor and could not have been denied compensation under § 328(c) solely because of its previous employment by or representation of American Tierra's creditors, such as Western Heritage or Surety Life. However, § 327(c) does not protect Sessions & Moore from disqualification and denial of compensation under § 328(c) for reasons other than employment by or

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9 For example, Rule 2014(a) of the Bankruptcy Rules requires that the application for employment disclose, among other things, all of the attorney's connections with the debtor, its creditors, or any other party in interest.

10 Since American Tierra filed for relief in 1981, the above-mentioned statutory provisions as they existed prior to the 1984 amendments apply in this case.

representation of a creditor. Other potential or actual conflicts of interest remain as independent grounds for disqualification and denial of fees.

Based on the foregoing statutory provisions and the record before it, this court is of the opinion that in addition to Sessions & Moore's representation of certain creditors of the debtor, Sessions & Moore represented or held interests adverse to the interest of the debtor or the estate and failed to adequately disclose these conflicts of interest to the bankruptcy court when they sought appointment as counsel for the debtor. The bankruptcy court acted soundly within its discretion in denying Sessions & Moore's request for compensation, in accordance with § 328, as a penalty for the conflicts. In this regard, this court believes that the following concerns, when viewed together, constitute conflicts of interest between Sessions & Moore and the debtor sufficient to allow the bankruptcy court to deny compensation for services rendered. This is especially so in light of Roy Moore's previous representation of the debtor and Western Heritage, a secured creditor, and Roy Moore's intimate relationship and affiliation with Western Heritage as a shareholder, director, and member of the Executive Committee of Western Heritage's Board of Directors.

First, Sessions & Moore failed to disclose Roy Moore's

status as a shareholder, officer,[11] and director of AID Financial, the parent of Western Heritage. Second, prior to its appointment as counsel for the debtor, Sessions & Moore failed to disclose the debtor's prepetition conveyance of Lot 61, Prospector Hills No. 8 subdivision, Salt Lake County, Utah, to Roy Moore, in consideration for Mr. Moore's services in locating individuals to purchase real estate from the debtor.[12] In performing their duties, counsel for the debtor have an obligation to look into conveyances such as this and to scrutinize transactions to determine whether or not a conveyance may be set aside or otherwise subject to attack by the debtor. Failure to actively pursue this matter, in light of Roy Moore's status as the debtor's counsel, raises some concerns of a conflict of interest. Third, Sessions & Moore did not disclose or actively seek to avoid or otherwise attack certain transactions directly or indirectly involving Western Heritage, Empire Development and/or Moore Development Corp. ("Moore Development"), and the debtor, whereby Western Heritage purportedly obtained security interests in certain lots owned by the debtor and/or

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11 Sessions & Moore's brief indicates that Roy Moore was never an officer of AID Financial or at least not an officer during his representation of the debtor in the bankruptcy proceeding. (Brief at 20-21).

12 The transfer of Lot 61 was subsequently listed in the debtor's Amendment No. 1 to the Statement of Financial Affairs for Debtor Engaged in Business, filed March 5, 1982.

transferred to Empire Development or Moore Development. In this regard, Western Heritage may have received defective title with respect to these lots because of the possibility of an invalid or improper conveyance or transaction. Although the record is somewhat ambiguous on this point, Western Heritage's security could have been called into question; and the transactions and potentially invalid security interests may have been subject to attack by the debtor if it had been advised properly.[13] Fourth, Sessions & Moore represented Charles Moore, a principal of the debtor, and/or certain business entities controlled by Charles Moore, in certain non-bankruptcy court proceedings, charging substantial portions of their fees for such representations to the estate rather than to Charles Moore or his other business

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13 What is important here is not the final outcome of whether or not the transfers or security interests actually could have been avoided or set aside by the debtor but the fact that since there may have been an invalid conveyance or transaction, counsel for the debtor should have scrutinized the transactions creating the secured claims against the estate or the liens against the property and actively search out the possibility of avoiding the conveyances and Western Heritage's security interests. The fact that Sessions & Moore did not learn about, discover, or investigate the possible discrepancy in the chain of title and did not actively seek to attack Western Heritage's security interests, raises some concerns of conflicting interests and the appearance of impaired impartiality in view of the fact that Roy Moore represented the debtor and Western Heritage, sat on Western Heritage's board of directors, and was a shareholder of Western Heritage, during the time when the transactions subject to attack were consummated.

entities.[14] As this court views the record, not only did Sessions & Moore's continued representation create potential conflicts of interest between Sessions & Moore and the debtor, but it also caused serious fee allocation problems, such as determining exactly how the debtor directly benefited from the representation and what proportion of the fees should actually be charged to the estate. Fifth, as the bankruptcy court noted, there is a possibility that some transactions directly or indirectly involving the debtor and South Village and General Electric may have called into question a security interest in favor of Western Heritage in property owned by the debtor. As mentioned, counsel for the debtor have an obligation to discover and pursue matters that may be beneficial to the estate and to scrutinize the validity of security interests and the propriety of transfers of property from the debtor.

As a final note, this court is of the opinion that the debtor's retention of an independent co-counsel did not adequately cure Sessions & Moore's conflicts of interest and that the bankruptcy court should not have to police bankruptcy proceedings for conflicts to determine whether or not the best interest of the estate is being served by counsel. Sessions & Moore should

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14 In at least one of the proceedings, Sessions & Moore represented Charles Moore in his capacity as a guarantor of obligations of the debtor.

not have applied for employment in this case. Had Sessions & Moore disclosed all their connections and affiliations with certain creditors of the debtor, the transactions affecting the debtor's estate and calling into question the validity of certain secured interests and conveyances, and the other potential conflicts of interest, this court believes that the bankruptcy court would not have approved Sessions & Moore's employment. In light of Sessions & Moore's conflicts of interest and their failure to fully disclose all conflicts that could have impaired the impartial and detached judgment required in the administration of the debtor's estate, the bankruptcy court correctly relied on § 328(c) in denying the request for compensation. The bankruptcy court's prior approval of employment, without the benefit of full disclosure, did not estop the subsequent denial of fees.

Accordingly,

IT IS HEREBY ORDERED that the bankruptcy court's order denying Sessions & Moore's application for compensation for services rendered on behalf of the debtor is affirmed.

Dated this 4th day of November, 1986.

David K. Winder
United States District Judge