NOT FOR PUBLICATION

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FILED

JUN 28 2001

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U.S. BANKRUPTCY COURT
EASTERN DISTRICT OF WASHINGTON

ENTERED

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UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF WASHINGTON

In Re: KENNETH EARL and LENORA JANE HAFF, Debtors.	No. 00-02953-W11 MEMORANDUM DECISION RE: UNITED STATES TRUSTEE'S MOTION FOR ORDER OF DISGORGEMENT AND DISALLOWANCE OF FEES OF DEBTORS' ATTORNEY

THIS MATTER came on for hearing before the Honorable Patricia C. Williams on June 12, 2001 upon the United States Trustee's Motion for Order of Disgorgement and Disallowance of Fees of Debtors' Attorney. The debtors were represented by Donald Hackney and the Assistant United States Trustee, Robert D. Miller, was present. The court reviewed the files and records herein, heard argument of counsel and was fully advised in the premises. The court now enters its Memorandum Decision.

FACTS

Mr. Donald Hackney, Mr. Charles Carroll and others were partners in the practice of law until the summer of 1999 when the partnership began to formally terminate. The relationship between Mr. Hackney and Mr. Carroll as well as former partners has gradually evolved from a partnership into a different arrangement. By the time of the commencement of this bankruptcy proceeding, the relationship between Mr. Hackney and Mr. Carroll had some aspects

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of a partnership and some aspects of an office sharing arrangement.

Mr. Carroll had represented Mr. Haff in an attempt to avert foreclosure on certain development property by a secured creditor. Mr. Haff owned several parcels of property in various stages of development but foreclosure had been commenced by the primary secured creditor. When Mr. Carroll was not successful in staying that foreclose, he introduced Mr. Haff to Mr. Hackney for the purpose of commencing a bankruptcy proceeding to avoid the foreclosure which was scheduled to occur within a few days. Mr. Hackney was able, on an emergency basis, to commence the bankruptcy on May 4, 2000 followed on May 19, 2000 by the filing of the Schedules, Statement of Financial Affairs and other pleadings, including a Statement of Compensation under B.R. 2016. The Schedules revealed an unsecured obligation to Mr. Carroll of approximately $22,000. Mr. Hackney had indicated to Mr. Haff that if someone objected to the representation due to the existence of this obligation, Mr. Hackney might refer the debtors to other counsel simply to avoid any problems. By the time of the first meeting of creditors on June 2, 2000, offers to purchase certain parcels of real estate had been received and the primary secured creditor had agreed that the offers should be accepted and had agreed to a lengthy extension of time to allow the debtors to liquidate other parcels and fully satisfy the secured obligation.

At the § 341 meeting, Mr. Hackney discussed with the United States Trustee the obligation owed to Mr. Carroll and the relationship between the two attorneys and the possibility of referring the debtors to other counsel if the existence of the obligation caused concern. At that time, it appeared as though the

case would promptly be dismissed due to the agreement with the secured creditor.

Unfortunately, the resolution of the debtors' financial problems did not occur as smoothly or as promptly as believed. Dismissal was delayed as it was determined that it would be preferable for the sale of the real estate to take place in the context of a Chapter 11 proceeding. Problems developed with the proposed sale which took time to resolve. It was not until October 3, 2000 that an order was entered approving the sale. The sale was closed and, pursuant to a United States Trustee's Motion to Dismiss, the case was dismissed on November 30, 2000.

At the time of the dismissal, the court retained jurisdiction to hear the dispute between the United States Trustee and Mr. Hackney concerning Mr. Hackney's fees. The debtor, with funds advanced from his father-in-law, had paid Mr. Hackney $1,500 pre-petition, which sum was, according to Mr. Hackney, fully earned and paid immediately prior to the filing of the petition. The Statement of Compensation filed on May 19, 2000 states that sum was received before filing from the debtors. Mr. Hackney's recollection is that the actual check for $1,500 was drawn on the debtors' account. Mr. Hackney assumes that at the time he knew the funds had been provided to the debtor by his father-in-law. The Statement of Compensation further states that legal fees will be billed at the hourly rates set forth in a separate agreement and fee applications will be made every 120 days.

Neither on May 19, 2000 or at any other time during the case did Mr. Hackney seek approval of his representation of the debtors. His explanation for not doing so is that firstly, he thought he

might refer the case out shortly after filing and, secondly, he thought the case would likely be dismissed once the agreement was reached with the secured creditor. The United States Trustee periodically during the case reminded Mr. Hackney that no motion to approve employment had been filed and suggested he do so. The United States Trustee also raised the question of whether the representation by Mr. Hackney was appropriate due to the obligation owed by the debtors to Mr. Carroll.

Currently the United States Trustee's position is that since Mr. Hackney was never employed, he cannot receive any post-petition fees and must disgorge the pre-petition fees. Mr. Hackney has never sought any fees, never asked the debtors to make any payment other than the initial $1,500, and testified that he will not do so in the future. Meanwhile, the debtors have, outside the scope of bankruptcy, successfully reorganized their financial affairs and paid all creditors except Mr. Carroll and another attorney in Idaho, both of whom Mr. Haff indicates will be paid within the next several weeks.

ISSUE

Should the failure to file an application for approval of employment result in disgorgement of compensation for pre-petition services?

DISCUSSION

In the roughly six months the bankruptcy case was pending no application to approve employment was filed.

> Court approval of the employment of counsel for a debtor in possession is *sine qua non* to counsel getting paid. Failure to receive court approval for the employment of a professional in accordance with § 327 and Rule 2014 precludes the payment of fees. (Footnote omitted).

In re *Shirley*, 134 B.R. 940, 943-44 (B.A.P. 9th Cir. 1992).

B.R. 2014(a) is clear and unambigious. It states that an application "shall be filed." Even though the failure to file an application to approve employment may have been inadvertent, that does not excuse an attorney from fulfilling the requirements of the Rule. Because no application to approve employment was filed, the employment was never approved and no post-petition compensation can be paid. *In re Shirley, supra. McCutchen, Doyle, Brown & Enersen v. Official Comm. of Unsecured Creditors (In re Weibel, Inc.)*, 176 B.R. 209 (B.A.P. 9th Cir. 1994). Clearly, Mr. Hackney's failure to seek approval of employment precludes him from receiving any compensation for post-petition services. Since Mr. Hackney has never asked for such compensation and never intends to do so, the present controversy concerns the compensation he received for pre-petition services.

B.R. 2014(a) not only requires the filing of an application to approve employment but also requires an attorney to disclose information in the application. 11 U.S.C. § 327(a) allows only those "that do not hold or represent an interest adverse to the estate, and that are disinterested . . ." to receive compensation. The mechanism which reveals information relevant to the determination of whether the attorney is disinterested is the application to approve employment. B.R. 2014 (a) requires not just a pleading but a verified statement "setting forth the person's connections with the debtor, creditors, or any other party in interest." Without such disclosure, no examination of any potential adverse interest can take place.

Consequently, the United States Trustee argues that the

failure to file the application for approval of employment prevents the attorney from receiving any compensation not because he was never authorized to represent the estate but because he did not fulfill the disclosure requirements.

It should be emphasized that the issue here is not whether Mr. Hackney is disinterested or holds an interest adverse to the estate due to his relationship with Mr. Carroll. The issue is what is the appropriate remedy for failing to disclose information sufficient for an examination of whether Mr. Hackney is disinterested. The requirements of B.R. 2014(a) are applied strictly. Failure to comply with disclosure rules is sanctionable conduct even if disclosure would have revealed no basis upon which to object. *Neben & Starrett v. Chartwell Fin. Corp. (In re Park-Helena Corp.)*, 63 F.3d 877 (9th Cir. 1995). The failure to disclose such information can result in a denial of all fees including disgorgement of fees already received. *Law Offices of Nicholas A. Franke v. Tiffany (In re Lewis)*, 113 F.3d 1040 (9th Cir. 1997)

It is within the court's discretion to require disgorgement and each case has to be examined on its facts. This case presents a reputable and experienced bankruptcy practitioner who was assisting a client in an emergency situation. He quite properly identified the potential issue under 11 U.S.C. § 327 and discussed it with his client. It is understandable that no application to approve employment and consequently no disclosure was made on May 4, 2000 under the circumstances of the case. However, by May 19, 2000, when the schedules were filed, the emergency had passed. It is the failure to file the application containing the necessary disclosures on that date or shortly thereafter which

causes the present controversy. Even though Mr. Hackney fully revealed the potential problem at the § 341 meeting, only those in attendance at that meeting had access to the information. Such disclosure, although commendable, is not in compliance with B.R. 2014(a). Mr. Hackney admits that the United States Trustee suggested the application be filed and that others in his office questioned his failure to file it. At its most simplistic, the reason for the non-disclosure through the application process was that the debtors' financial problems were being solved and Mr. Hackney believed that the proceeding would be dismissed "very soon". Unfortunately, week followed week and procedures took place at their usual deliberate pace and "very soon" become 6 months.

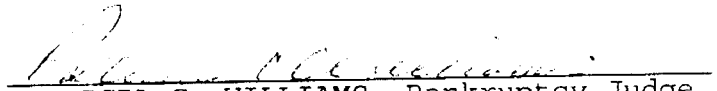
The policy underlying B.R. 2014 is to promote disclosure. There is no duty or process by which the United States Trustee or interested parties may search the record to determine if a potential adverse interest exists. All those in the bankruptcy system rely upon the disclosures made pursuant to B.R. 2014. Counsel for the debtor has an affirmative duty to file an application with appropriate disclosures. The failure to perform that duty must carry consequences. *In re Robert Fjeldheim,* _____ B.R. _____, 1993 W.L. 590145 (Bankr. D. Mont. 1993).

Mr. Hackney typically is a conscientious bankruptcy practitioner and this failure on his part was not a deliberate omission, but a result of his mistaken optimism. However, "the rule is the rule" and violation of the rule results in not only the loss of any post-petition compensation which would otherwise have been earned, but also disgorgement of the pre-petition fees. Therefore, the $1,500.00 pre-petition payment must be disgorged.

The court will enter an order to that effect.

The Clerk of the Court is directed to file this Memorandum Decision and provide copies to counsel.

DATED this 28th day of June, 2001.



PATRICIA C. WILLIAMS, Bankruptcy Judge