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Consumer Session

Trustees, Unusual Assets and the Unwary: How to Keep a Discharge and Not Be Sued for Malpractice

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TRUSTEES, UNUSUAL ASSETS AND THE UNWARY:
HOW TO KEEP A DISCHARGE AND NOT
BE SUED FOR MALPRACTICE

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I. Introduction

The purpose of these materials is to highlight “unusual” assets in Chapter 7 cases and to initiate a discussion about unwary debtors and their bankruptcy counsel.

As federal and state exemption amounts continue to increase (especially in Ohio, being an opt-out state), Chapter 7 Trustees are increasingly looking for “unusual” assets to recover and sell in order make a distribution to unsecured creditors.

As trustee, I have come across several cases where these “unusual” assets were properly disclosed in the bankruptcy schedules, but the debtors and their counsel were seemingly unaware that the assets would *actually be administered*.

Some examples: 1) private note and mortgage held by a debtor on out-of-state real property; 2) an irrevocable insurance trust where the debtor was a named beneficiary of insurance proceeds; and, 3) real estate owned by debtor where debtor’s elderly parent held a life estate interest.

In these cases, the debtors and their counsel did not realize that a trustee would actually attempt to sell and monetize such assets. The fact of the matter is that trustees are routinely bombarded with solicitations from investors that buy these types of assets.

In each of the examples above, I had a ready, willing and able investor that was prepared to purchase the “unusual” asset from the bankruptcy estate. In the case where the debtor owned the private note and mortgage, the asset was ultimately sold to an investor. However, in the cases involving the irrevocable insurance trust and the debtor’s remainder interest, other solutions were found, but not without much consternation on the part of the debtors and their counsel. The assets were sold and meaningful distributions were made to unsecured creditors.

In our time today, we plan to also discuss how trustees can go about selling lien interests, with or without carve-outs, selling jointly owned property, and other “unusual” assets.

II. Treatment of Certain Liens

A. Pertinent code provisions:

1. 11 U.S.C. §724(a) provides that the trustee may avoid a lien that secures a claim of a kind specified in section 726(a)(4) of this title.
2. 11 U.S.C. §726(a) states that except as provided in section 510 of this title, property of the estate shall be distributed –

(4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief of the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;
3. 11 U.S.C. §551 – Automatic preservation of avoided transfer provides that any transfer avoided under section 522, 544, 545, 547, 548, 549, or 724(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate.

B. An example:

Debtor owns a home in Cincinnati that has a value of \$300,000 and debtor uses the real estate as his principal residence. Ohio, an opt-out state, allows debtor to claim a homestead exemption in residential real estate in the amount of \$136,925.

There is a first mortgage on debtor's real estate, balance of \$150,000.

There is a second mortgage on debtor's real estate, balance of \$50,000.

The IRS holds a §726(a)(4) tax lien in the amount of \$50,000 against debtor, for penalties, which has attached to debtor's real estate.

Debtor claims the equity in the real estate, in the amount of \$50,000, as exempt under Ohio law (Ohio R.C. 2329.66(A)(1)(b)).

1. The unwary debtor and counsel may walk into a trap in this case believing that the Chapter 7 trustee will have no interest in administering debtor's real estate as an asset of the bankruptcy estate. However, as set out above, the trustee can avoid the IRS tax lien for penalties under 11 U.S.C. §§724(a) and 726(a)(4) and then move to sell debtor's real estate.
 - a. The Chapter 7 Trustee could approach the IRS or the U.S. Attorney and propose an agreed order avoiding the lien. Once avoided, the trustee can preserve the amount of the federal tax lien (\$50,000) for the benefit of the bankruptcy estate and then use the monies to pay unsecured creditors. These monies are *not* exempt; they become property of the bankruptcy estate.
 - b. By agreeing to the lien's avoidance, the IRS could receive monies sooner than if it simply sat on its lien. Under 11 U.S.C. §507, a priority tax claim gets paid ahead of other general unsecured claims. The IRS would receive payment upon the Trustee's sale of the real estate, rather than waiting for some other event such as a foreclosure or sale.
 - c. Debtor would receive the remaining balance as part of the homestead exemption, *after* payment of the first and second mortgages and the amount of the IRS tax lien that was avoided and preserved for the benefit of the estate.
2. The unwary debtor and counsel may also believe that if the Chapter 7 trustee does not exercise his lien avoidance powers under 11 U.S.C. §§724(a) and 726(a)(4), then the debtor can then bring an action to avoid the penalty component of the tax lien under 11 U.S.C. §522(h) and preserve that lien for debtor's benefit under the homestead exemption. In *Hutchinson v. United States* (Bankr. E.D. Cal 2018), the court found otherwise.
 - a. The court ruled that the bankruptcy code precludes a debtor from avoiding the IRS tax lien for penalties. And, because a debtor cannot avoid this lien, the debtor cannot preserve it for his own benefit.
 - b. 11 U.S.C. §551 controls, and if the trustee avoids the tax lien, it is preserved for the benefit of the estate, and derivatively, creditors.

III. Unreported Decision by Judge Walter: *In re Villarreal* 15-33218 / Dec 26, 2016

- A. The pertinent statute in this case is 26 U.S.C. §6321 – Lien for Taxes, which provides that: if any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.
- B. In the *Villarreal* case:
1. Debtors owned residential real estate with a value of about \$445,000.
 2. There were 2 mortgages on debtors' real estate totaling \$150,000 and a federal tax lien of approximately \$5,500.
 3. Debtors claimed exemptions in the real estate totaling \$265,800.
 4. In addition, debtors owed non-dischargeable unsecured priority tax debt to the United States in the approximate amount of \$185,000.
- C. On its face, debtors' home appeared to have *no* equity after deducting the mortgages, tax lien and homestead exemptions from the value of the property.
- D. However, the IRS took the position, which the trustee supported, that under 11 U.S.C. §522(c), non-dischargeable tax debt provides an exception to the rule that exempt property is not liable during or after the case for pre-petition debt.
- E. Under 26 U.S.C. §6321, the IRS has an assessment lien (whether or not recorded) on all property of a debtor, as opposed to property of the estate, and that statutory assessment lien attaches to the debtor's property, including proceeds for a real estate sale that ordinarily would go to the debtors pursuant to their homestead exemption.

- F. In *Villarreal*, the court accepted the argument that the statutory assessment lien of the IRS “pierces” the debtors’ homestead exemption, and the proceeds from the sale of real estate could be paid over to the IRS. Essentially, the court found that a Chapter 7 trustee may sell real property to pay an IRS assessment lien that attaches to debtors’ homestead exemption.
- G. *Warning to the unwary* – if the IRS asserts an unrecorded assessment lien, due to the existence of non-dischargeable taxes, any money that otherwise would go to the homestead exemption can be paid to the IRS, pursuant to its assessment lien, and the trustee may liquidate property for this purpose.

IV. Sale of Debtor’s interest in Irrevocable Life Insurance Trust

- A. In paragraph 14 of the Statement of Financial Affairs, “Property held for another person”, debtor listed an interest in an “Irrevocable Life Insurance Trust” and set forth a value of “\$325,000”. This piqued the interest of the trustee and the debtor was required to provide a copy of the trust and other supporting documents.
- B. Upon review of the documents, trustee determined that the debtor was not “holding property for another person”; debtor was a beneficiary under the irrevocable trust and the value of debtor’s interest in the trust was more than enough to pay administrative claims and creditors at 100%.
- C. Trustee advised the unwary debtor and counsel that debtor’s interest in the trust had present value to the bankruptcy estate. Debtor responded to trustee that the grantor of the trust planned to stop paying the life insurance premiums, which would make the asset “valueless”.
- D. Trustee contacted investor. After review of the pertinent documents, investor determined debtor’s interest in the trust was “significant” and offered to pay the premiums for the life insurance policies in order to step into the shoes of debtor.
- E. Trustee advised unwary debtor and counsel of his intent to sell debtor’s interest in the trust. Settlement was quickly reached. Grantor agreed to pay estate enough money to pay administrative costs and creditors at 100%.

V. FRBP 3004: Filing of Claims by Debtor or Trustee

- A. Rule 3004 provides that “[i]f a creditor does not timely file a proof of claim under Rule 3002(c) or 3003(c), the debtor or *trustee* (emphasis added) may file a proof of claim within 30 days after the expiration of the time for filing claims prescribed by Rule 3002(c) or 3003(c), whichever is applicable. The clerk shall forthwith give notice of the filing to the creditor, the debtor and the trustee.
- B. Some courts and UST offices seem opposed to a Chapter 7 trustee filing claims, even though it is authorized by Congress. One basis for this opposition is the belief that the trustee is filing claims to receive a windfall.
- C. There are valid reasons for a trustee to file claims:
 1. The code and rules permit the filing of claims by trustees; and, the Chapter 7 Trustee Manual provides that the trustee has the ability to file claims, but should exercise caution in doing so. When filing claims, the trustee must treat similarly situated creditors equally.
 2. Moreover, filing claims to maximize returns to creditors is consistent with trustee duties.
- D. Examples of cases where trustee files claims:
 1. Large recovery from lawsuit or sale of assets that exceeds amount of claims filed.
 2. Large recovery and a creditor holding non-dischargeable debt fails to file claim.
 3. Trustee files claims to protect creditors when it appears the settlement of some claim or action will be substantial and lead to a meaningful distribution to creditors.

VI. Short Sales / BK Global / Auction.com

- A. This has become another way for trustees to sell real estate assets that appear on their face as being wholly secured and/or exempt.
- B. BK Global (traditional MLS sales) and Auction.com (auction sales) review the bankruptcy schedules for all the cases on a trustee's upcoming docket.
- C. The trustee then receives an email from BK Global or Auction.com that provides a list of cases involving properties that are pre-approved for short sales.
- D. The trustee then files appropriate applications to employ professionals and a motion to sell real estate. A reserve price for the real estate is set.
- E. BK Global and Auction.com then work with the listing agent to market the real estate for a fixed period of time.
- F. If the reserve price is met, the lender who holds the first mortgage on debtor's real estate agrees to pay the bankruptcy estate a carve-out, which is a percentage of the sales price or the winning bid (usually \$5,000 - \$7,500).
- G. This is an area that becomes tricky in situations where the debtor seeks to retain the real estate v. surrender the real estate.
- H. Our UST is concerned with situations where an entity proposes to purchase real estate from the trustee for the sole purpose of renting it back to the debtor until such time a foreclosure is completed by the first mortgage lender. The UST seeks to avoid a situation where it appears the trustee and the bankruptcy system is taking advantage of a debtor's situation.

**TRUSTEES,
REVOCATION OF DISCHARGE
AND LEGAL MALPRACTICE CLAIMS**

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INTRODUCTION

The purpose of these materials is to highlight what constitutes sufficient misconduct by a debtor that leads courts to conclude that the discharge should either be denied or revoked. In the ugliest of these situations, beyond potential or actual criminal activity by debtors, a trend has arisen when a trustee or debtor seeks recovery of damages from debtor's counsel. While it seems incongruous that a debtor who eventually is either convicted or pleads guilty to bankruptcy crimes would seek indemnification from debtor's counsel for negligently omitting assets, it is a pattern that has emerged and that the less than diligent counsel should be aware.

A criminal conviction almost necessarily requires intent by the debtor to deceive or to intentionally omit concealed assets. But, the criminal convictions have not prevented debtors, or trustees, from seeking to prosecute a malpractice claim against debtor's counsel. This discussion will review a series of cases that establish what can be grounds for either denial or revocation of a discharge; and, finally, different fact patterns that result in debtor's counsel being pursued for payment.

Some cases appear obvious when read. And in those instances, it would appear that a debtor is deceiving not only the court and creditors but also his own counsel. Take, for example, the case of *In re: Fonner*, 573 B.R. 741 (Bkrcty. S.D. Ohio 2017). In that decision, Judge Caldwell in Columbus revoked the chapter 7 discharge of the debtor because his discharge had been obtained by fraud. The omission by the debtor was his failure to disclose his interest in oil and gas leases. What makes this case obvious is that the debtor received \$55,000.00 for signing a mineral lease less than one (1) month before he filed the bankruptcy. In addition, the debtor failed to disclose income he had received from the sale of musical instruments. The musical instruments grossed a total of less than \$4,000.00, and the net to the debtor was approximately \$3,000.00. None of the

income received from signing the oil and gas leases was included in the Means Test, and the debtor met and qualified for chapter 7 when that income was not included. The leases were not revealed by the debtor until after questioning by the trustee. Yet, despite being told not to cash any further checks, the debtor continued to do so, including a year after these leases were disclosed.

The Court, in its opinion, advised debtor's counsel that counsel, "Shoulders a significant measure of ... responsibility in the form of restrictions, disclosures, and requirements imposed upon attorneys as 'debt relief' providers. Further, upon filing, all existing legal and equitable interests are fair game for trustee liquidation, subject only to a limited amount of exemptions intended to strike a balance between debtors and creditors." *Id.*, 573 B.R. 744 (citations omitted). The Court found, in addition, that while the trustee may have been aware of undisclosed assets because he received "trickles of information," that knowledge was not imputed to the United States Trustee. The court revoked the discharge of the debtor because the court found that the debtor engaged in conduct that concealed assets which had value. The musical instruments were a bonus throw to revoke the discharge of the debtor.

Courts consistently held that when the debtor engaged in material fraud, which is defined as conduct that would have resulted in the denial of the chapter 7 discharge had it been known at the time of the discharge, revocation of the discharge can occur regardless of time. See 11 U.S.C. §§ 727(a)(4) and (d)(1). Courts do require that the fraud be material, and the Debtor engage in the fraud knowingly and intentionally. See, for example, *In re: Jones*, 736 F.3d 897 (9th Cir. 2013). In determining whether a matter is material, for purposes of revoking the discharge, a court does not center on whether the omitted assets is worthless but whether the omission relates to a material matter. Materiality is defined as whether the omission is related to the debtor's transactions or his bankruptcy estate or concerns discovery of assets or the existence and disposition of the debtor's

property. *In re: McNally*, 2018 WL 2974411 (10th Cir. 2018), opinion dated June 13, 2018, citing *In re: Calder*, 907 F.2d 953 (10th Cir. 1990). In the *McNally* case the Tenth Circuit upheld the bankruptcy court's finding that an omission of assets was material. The bankruptcy court found that the assets were not of the debtor but of a third party and thus denied the request to revoke the discharge.

The discharge provisions are contained in 11 U.S.C. § 727. The presumption is that the debtor will receive a discharge. However, exceptions to the granting of a discharge exist throughout 11 U.S.C. § 727. Grounds for denial of a debtor's discharge must be established by a preponderance of the evidence. *Keeney v. Smith (In re: Keeney)*, 227 F.3d 679 (6th Cir. 2000). The exceptions to discharge are construed liberally in favor of the debtor and strictly against the objecting party. *In re: Keeney*, 227 F.3d 683. One case in the Southern District of Ohio that sets forth the grounds for denial of discharge is found in the case of *Harker v. West (In re: West)*, 328 B.R. 736 (Bkrcty. S.D. Ohio 2004). In an opinion issued by Judge Hoffman, the Court goes to great length to set forth the grounds for denial of the discharge. The facts of the case focus upon the Debtor's actions regarding her jewelry. It is clear that the Court found that the debtor was not prompt in her conduct in turning over jewelry. The statement of values regarding the jewelry were suspect. Whether the jewelry had great value was not found to be important as to materiality but whether it concerned the discovery of assets, business dealings, or existence and disposition of estate property. The court found that the representation of the jewelry's value was material. While the debtor listed a value of \$2,000.00, the court found that the jewelry in question ranged from \$3,860.00 to \$8,900.00, depending on the basis of the valuation (pawn shop value v. retail value).

The trustee in the *West* case argued that the debtor knowingly and fraudulently undervalued the jewelry. The Court found that the value of the jewelry given by the debtor was based on

attorney's advice to list the pawn shop value only. The Court ultimately found that the undervaluation of jewelry did not rise to the level of being a knowing and fraudulent misrepresentation to warrant the denial of discharge. The debtor followed her counsel's instruction to estimate a pawn shop value. Based on advice of counsel, the Court would not go so far as to find that the debtor acted in bad faith. The Court made this finding despite the fact that the debtor was very slow in the turnover of assets, including a sapphire ring.

The Court did find, however, that the debtor was not credible with regard to why she failed to turn over the ring and subsequently took it to a jeweler (it took the debtor 19 months to turn over the ring). Because of her failure to turn over the sapphire ring, the Court did find that the debtor engaged in conduct that was motivated by an intent to hinder, delay, and defraud the trustee and her creditors and denied her discharge. Thus, while her counsel's advice may have saved the debtor initially with the valuation of the jewelry, ultimately it was her conduct and failure to turnover promptly all jewelry, especially a sapphire ring, that led to the denial of the debtor's discharge.

Nothing in the *West* case indicated that a party contemplated further action against debtor's counsel. The court did not discuss whether debtor's counsel acted in a manner that would arise to a level of malpractice, despite the advice that he gave to his client on how to value the jewelry. The court did find that the advice was erroneous. However, the court did not suggest that the advice was actionable.

Several cases have arisen in which as a result of the discharge revocation issues, the debtor, or the trustee, then assert a claim against counsel alleging legal malpractice. For example, in the case of *In re: Almasri*, 378 B.R. 550 (Bkrtcy. N.D. Ohio 2007), Judge Baxter had already revoked the debtor's discharge. The basis of the denial of the discharge focused upon

the failure of the debtor to disclose a bank account and a business. The total amount of the debts that were not discharged exceeded \$260,000.00. Subsequently, the trustee filed an adversary proceeding against debtor's counsel alleging that he committed legal malpractice. Further, the trustee stated that since the damages to the debtor was the amount of the unsecured debts, and debtor's counsel failed to list the bank account and the business, counsel should pay to the trustee the amount of the damages caused, or the \$260,000.00, plus, in unsecured debt that was listed. The Court found that the trustee's allegations regarding the activities of debtor's counsel related solely to acts that occurred pre-petition in the preparation of the petition and schedules.

The Court found, in denying counsel's motion to dismiss, that the trustee had standing to bring the action because the alleged malpractice was property of the debtor's estate as defined in 11 U.S.C. § 541. The Court further found that the claim was rooted in the language of all legal or equitable interest of the debtor as of the commencement of the case, and these actions included causes of action which may not have existed at the time of filing. The Court held, therefore, that under Ohio law, the trustee had sufficiently pled the allegations to establish a malpractice claim. The claim existed as a result of pre-petition activity, and that damages resulted from that activity, namely the denial of discharge of \$260,000.00 in unsecured debt, was also pre-petition.

The Court also denied the motion to dismiss on counsel's premise that the trustee was not a contractual party and, therefore, could not assert the malpractice claim. The Court held that the Trustee is not barred because of the lack of direct contractual obligation with counsel. Rather, the trustee stands in the shoes of the debtor. The damage suffered was not by the trustee but by the debtor. However, the court found that the trustee could not only bring the action, but was required to bring the action.

In the case of *Labgold v. Regenhardt*, 573 B.R. 645 (E.D. Va. 2017), District Judge Trenga found that the malpractice claim was property of the bankruptcy estate. Because the malpractice claim was in fact property of the bankruptcy estate, the plaintiff in that action, the debtor himself, lacked standing to bring the action. The Court found that the actions complained of by the debtor were rooted in pre-petition activity, even though the debtor asserted that it was events that occurred after the bankruptcy petition was filed that cause the injury. Inasmuch as the court found that the plaintiff/debtor did not have standing, he then remanded the action back to state court despite his finding that the malpractice claim was property of the bankruptcy estate. The case is ripe for the trustee to stand in the shoes of the debtor and continue with the malpractice action.

In an opinion that may be of some well-known notoriety, the District Court in New Jersey, ruling on matters of standing primarily, essentially upheld a settlement agreement between the Trustee in Bankruptcy and Teresa Guidice, who asserted a malpractice claim asserted against her counsel. The settlement was ultimately divided between Ms. Guidice and her trustee, with the split being 55-45. The holding essentially denied the bankruptcy counsel who was the subject of the malpractice action from attacking the settlement for lack of standing between the debtor and the trustee. The caution is that despite the fact that the debtor pled guilty to federal bankruptcy crimes in which she agreed that she intentionally withheld assets of the estate, an action could lie against her bankruptcy counsel.

In essence, counsel is faced with a situation in which the debtor has engaged in intentional and fraudulent misconduct, which deprives creditors of the opportunity to reap assets because they are not disclosed. Further, they are not disclosed to counsel. And, because these assets are not disclosed to counsel, counsel is now sued for malpractice for failing to list assets which the Debtor intentionally concealed. This author does not present a cure for this issue. These are concerns to

counsel. Counsel needs to insist in writing that the debtor makes full disclosure of one's assets to the Court. This author suggests, particularly in high-profile cases such as *Guidice*, that meticulous attention be given by counsel to ensure that due diligence is exercised.

A cautionary note is the case of *Biesek v. Soo Line R.R. Co.*, 440 F.3d 410 (7th Cir. 2006). In that case, the debtor brought an FELA claim after his bankruptcy was filed without ever disclosing it in the bankruptcy. The Seventh Circuit upheld the judgment that denied the debtor the right to prosecute the action, but found that the FELA claim was in fact property of the bankruptcy estate. In this case, the debtor and the trustee signed a stipulation in which the first \$7,000.00 of any recovery would be turned over to the trustee. In exchange, the trustee agreed with the representation that the omission of the FELA claim from the bankruptcy schedules had been inadvertent. Despite this agreement, the District Court dismissed the action based upon judicial estoppel. The Seventh Circuit opined "instead of vaporizing assets that could be used for the creditors' benefit, District Judges should discourage bankruptcy fraud by revoking the debtors' discharges and referring them to the United States Attorney for potential criminal prosecution." *Biesek*, 440 F.3d 410, 413. The Seventh Circuit further raised the question as to where the trustee was. The stipulation referred to was found to be invalid for lack of notice to creditors. Thus the FELA claim remained property of the estate. However, this particular claim was not going to be prosecuted by the debtor for his benefit, despite the agreement with the trustee.

A case that is particularly troubling for the unwary counsel, is *In re: Blasingame*, 709 Fed.Appx. 363 (6th Cir. 2018). While this case is not to be published, and the proper result was eventually reached, this case is illustrative of the issues that face counsel. In fact, this case is illustrative of the issues that face non-bankruptcy counsel in bankruptcy situations. In this case, the debtors discussed their financial issue with a lawyer who they knew by the name of Grusin.

Grusin advised the debtors he did not practice bankruptcy, he was not qualified to file a bankruptcy on their behalf, and instead referred them to another attorney named Fullen who was an experienced bankruptcy lawyer in the Memphis, Tennessee, area. The bankruptcy was ultimately filed.

The chapter 7 trustee discovered that the debtors did not list several trusts in which they had at least some interest in. They were neither scheduled nor listed in the Statement of Financial Affairs. As a result, a creditor filed an action objecting to the debtors' discharge for fraudulent concealment. That action was ultimately sustained on the creditor's favor, and the debtors' discharge was withheld due to violations of 11 U.S.C. §§ 727(a)(4) and (a)(5) for failure to disclose and making false oaths. Subsequently, a bankruptcy court held evidentiary hearings on the debtors' motion for relief from judgment pursuant to Rule 60(b).

The court entered sanctions, ultimately, against the non-bankruptcy lawyer and the bankruptcy lawyer under Rule 9011. The creditor offered evidence that both lawyers, non and bankruptcy lawyer, were negligent in how they handled the bankruptcy and requested fees, costs, and expenses for bringing the 727 action. The court ultimately order Grusin to disgorge any fees and pay \$20,000.00 to the trustee and complete 15 hours of continuing legal education. Additionally, he was ordered to pay both the creditor and the trustee an additional amount in fees and expenses, which was later set at \$75,000.00. Grusin, who never represented the debtors in the bankruptcy, appealed.

The Bankruptcy Appellant Panel vacated the Bankruptcy Court's orders that imposed sanctions against the non-bankruptcy lawyer. That decision was appealed to the Sixth Circuit. The Sixth Circuit ultimately held that no sanctions were appropriate. The Court upheld the reversal by the BAP because the creditor had not employed the safe harbor provision in Rule 9011, and,

since Grusin was not the attorney of record, sanctions were not appropriate. The Sixth Circuit found that the bankruptcy was filed by another attorney and that he had the full responsibility for the filing of the Petition and the information therein. The Court found that the named bankruptcy attorney in fact did represent the debtors, prepared all of the schedules, and made the decision on whether to include the information regarding the trusts. Even though Grusin, the non-bankruptcy lawyer, may have had some involvement with the bankruptcy case, it was the named bankruptcy counsel who signed the Petition and who was responsible for the information in it, or not within it. Thus, the lesson to be learned is when you make a handoff, make that handoff complete.

CONCLUSION

Counsel meeting with debtors obviously need to be concerned about full disclosure. Counsel are not the insurers of their clients. However, it is increasingly apparent that when matters that result in the loss of a discharge occur, either the debtor or the trustee is looking for someone else to pay. Careful attention must be given, particularly in cases involving significant economic claims, or simply high-profile cases, to be not only concerned, but wary about the advice given to one's client. Diligence is paramount. Providing written advice about the necessity for making full disclosure, maintaining records, providing those records, and other matters required under the Code is vital. Counsel should not file the Petition unless all of that information is made available to counsel to review prior to filing. The refusal of the debtor to turnover what counsel believes is pertinent information is a flag that should alert counsel as to whether continued representation is warranted. At the very least, letters addressing the failure to submit information requested and the consequences that debtors may suffer as a result of their failure to turnover that information, are necessary.

For a debtor to lose a discharge is traumatic. For counsel to be sued for losing that discharge is even more traumatic. Despite the fact that the debtor must engage in intentional misconduct in order to lose a discharge, this has not stopped either the debtor or trustee from seeking recovery from debtor's counsel for negligence for failure to make full disclosure even when the debtor has intentionally omitted material information or data.

Counsel must be thorough and check all resources, such as PACER, other courts, and public web sites to confirm what the debtor has disclosed. Debtors do overlook lawsuits, and assets, especially "odd" assets such as trusts, inheritances, and "soft" assets.

Diligence requires homework. Demand in writing that the debtor make full disclosure. Advise the consequences of not making full disclosure.

With these actions ensure that counsel will not be sued? That is unknown. But these types of steps minimize legal exposure.

AMERICAN BANKRUPTCY INSTITUTE

Case 3:15-bk-33218 Doc 98 Filed 12/27/16 Entered 12/27/16 15:47:45 Desc Main Document Page 1 of 11

This document has been electronically entered in the records of the United States Bankruptcy Court for the Southern District of Ohio.

IT IS SO ORDERED.



L. S. Walter
Lawrence S. Walter
United States Bankruptcy Judge

Dated: December 27, 2016

**UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION AT DAYTON**

In re: :
 :
 FERNANDO A. VILLARREAL and : Case No. 15-33218
 : Chapter 7
 SUZANNE VILLARREAL, : Judge L. S. Walter
 :
 :
 Debtors. :

**DECISION AND ORDER SUSTAINING THE UNITED STATES’
OBJECTION TO THE DEBTORS’ HOMESTEAD EXEMPTION**

Factual Background

On September 30, 2015, the debtors, Fernando and Suzanne Villarreal (the “Debtors”) filed a petition for relief under Chapter 13 of the Bankruptcy Code. The Debtors scheduled their residence located at 123 W. Hadley Road, Dayton, Ohio (the “Property”) as jointly held in fee simple with a value of \$443,000. (doc. 144). The Debtors also scheduled two mortgages on the Property as well as secured claims of the State of Ohio and the Montgomery County Treasurer. In addition, the Debtors scheduled the Internal Revenue Service (“the United States”) as holding a secured claim in the amount of \$5,053.50, an unsecured priority claim in the amount of

\$113,368.11 and a non-priority unsecured claim in the amount of \$487.04. *Id.* The United States has filed a proof of claim in this case, which has been amended three times. The current iteration, claim 1-4, is in the aggregate amount of \$752,746.57, allocated as follows: a \$562,476.53 non-priority unsecured claim, a \$185,216.54 unsecured priority claim, and a \$5,5053.50 secured claim.¹ The Debtors claimed the full \$265,800 homestead exemption for their residence pursuant to Ohio Revised Code § 2329.66(A)(1)(b).²

On January 20, 2016, the United States moved to convert the case to Chapter 7. doc. 37. Following a March 17, 2016 hearing, the court sustained the United States' and the Chapter 13 Trustee's objections to confirmation of the Debtors' Chapter 13 plan and granted the United States' motion to convert. An order was entered on March 21, 2016. Paul Spaeth was appointed as the Chapter 7 Trustee (the "Trustee").

¹ According to the United States, "[t]he secured claim reflects that the IRS released notices of federal tax lien for most of the assessed tax liabilities based on a levy to offset a Medicare payment which satisfied most of the assessed tax liabilities but then had to reverse the transfer because Medicare had issued the payment in error." doc. 75 at 2 n. 1.

² Section 2329.66(A)(1)(b) provides:

(A) Every person who is domiciled in this state may hold property exempt from execution, garnishment, attachment, or sale to satisfy a judgment or order, as follows:
* * *

(1)(b) In the case of all other judgments and orders, the person's interest, not to exceed one hundred twenty-five thousand dollars, in one parcel or item of real or personal property that the person or a dependent of the person uses as a residence.

Ohio Rev. Code § 2329.66(A)(1)(b). The Ohio homestead exemption statute is indexed to inflation and the interest for a person allowed to be exempted was \$132,900 as of the petition date. *See* Ohio Rev. Code § 2329.66(B) (requiring an adjustment to the dollar amounts in § 2329.66 beginning April 1, 2010 and every third year thereafter).

On June 9, 2016, the United States objected to the homestead exemption of the Debtors (doc. 75). Dr. Villarreal is a physician doing business as Fernando A. Villarreal, M.D., Inc. (the “Corporation”). Based on an investigation into the Corporation, the United States has alleged, that both Debtors were “responsible persons” who failed to pay withholding taxes for the Corporation. Dr. Villarreal is the 100 % shareholder of the Corporation. Under alter ego and veil-piercing doctrines, the United States asserted that both Debtors are responsible for the Corporation’s taxes. *See also* Declaration of Revenue Officer Michael Louderback (doc. 37-1). The United States argued that, pursuant to 11 U.S.C. § 522(c)³, the Debtors’ homestead exemption did not apply to the tax debt owed the United States because, under various theories, the tax debt was a priority debt under 11 U.S.C. § 523(a)(1). While the United States recognized § 522(c)(1) as a self-

³ Section § 522(c) states in relevant part that:

Unless a case is dismissed, property exempted under this section, property exempted under this section is not liable during or after the case for any debt of the debtor that arose, or that is determined under section 502 of this title as if such debt had arisen, before the commencement of the case, except---

- (1) A debt of a kind specified in paragraph (1) or (5) of section 523(a)(in which case, notwithstanding any provision of applicable nonbankruptcy law to the contrary, such property shall be liable for a debt specified in such paragraph);
- (2) A debt secured by a lien that is –
 - (A)(i) not avoided under subsection (f) or (g) of this section or under section 544, 545, 547, 549, or 724(a) of this title; and
 - (ii) not void under section 506(d) of this title; or
 - (B) A tax lien, notice of which is properly filed[.]

11 U.S.C. § 522(c)(1) and (2).

2018 MIDWEST REGIONAL BANKRUPTCY SEMINAR

Case 3:15-bk-33218 Doc 98 Filed 12/27/16 Entered 12/27/16 15:47:45 Desc Main Document Page 4 of 11

executing provision, it filed the objection because it intended to pursue its claim against the proceeds that may result from the sale of the Debtors' homestead by the Trustee during this case.

The Debtors' response (doc. 83) asserted that the Trustee could not liquidate the Property on authority of the unreported decision of *In re Hibbard*, 08-36322, ECF No. 296 (Bankr. S.D. Ohio Aug. 18, 2010) (Humphrey, J.). In *Hibbard*, the ex-spouse of one of the joint debtors held a large domestic support obligation claim (the "DSO Creditor"). The DSO Creditor moved the court to require the Chapter 7 trustee to transfer exempt funds held by the trustee to the DSO Creditor and to do the same for any future exempt funds. In addition, the DSO creditor sought to have any exempt assets "remain in their current state" during the pendency of the Chapter 7. *Id.* at *2. The *Hibbard* decision analyzed § 522(c)(1) and determined, "regardless of any other applicable non-bankruptcy law, a DSO creditor . . . can pursue exempt assets." *Id.* at *3. However, the *Hibbard* decision also determined that the trustee could not distribute exempt assets because a chapter 7 trustee, pursuant to 11 U.S.C. §§ 507 and 704 was limited to the distribution of estate assets. Ultimately, despite various favorable changes to the Bankruptcy Code included in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 to benefit DSO creditors, the *Hibbard* decision determined that such changes did not authorize chapter 7 trustees to distribute exempt assets to creditors. *See also In re Quezada*, 368 B.R. 44 (Bankr. S.D. Fla. 2007) (chapter 7 trustee could not administer exempt homestead on behalf of a DSO creditor). The United States argues that its unique status as a holder of an un-recorded statutory assessment lien allows it to "pierce" the exemption of the Debtors and be paid from any proceeds of a sale of the homestead by the Trustee. *See* doc. 83 (reply of the United States). *See also* doc. 87 (memorandum of the Trustee).

The court held a hearing on September 8, 2016. *See* doc. 84 (scheduling order) and doc. 94 (transcript of hearing). Following that hearing, the court ordered post-hearing briefing. (doc. 89). Pursuant to that scheduling order, the United States filed a supplemental brief (doc. 92), the Debtors filed a supplemental brief (doc. 96) and the United States filed a response (doc. 97). The issue being solely one of law, the court took the matter under advisement.⁴

Jurisdiction

This court has jurisdiction pursuant to 28 U.S.C. § 1334(b) and the Standing Order of Reference in this District. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(B) and the court has constitutional authority to enter a final decision in this contested matter.

Analysis

In addressing exemption questions, it must be remembered that the “principal purpose of the Bankruptcy Code is to grant a ‘fresh start’ to the ‘honest but unfortunate debtor.’” *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365, 367 (2007) (citation omitted). Consistent with this policy, the Bankruptcy Code allows a debtor to claim certain property as exempt from creditors’ claims. 11 U.S.C. § 522. As an alternative to the federal exemptions contained in § 522(d), the Bankruptcy Code allows a state to “opt out” and use its own state exemptions. Ohio is an “opt-out” state. Ohio Revised Code § 2329.662. Ohio exemption provisions are to be construed liberally in favor of the debtor. *Daugherty v. Cent. Trust Co. of Northeastern Ohio, N.A.*, 504 N.E.2d 1100, 1104-05 (Ohio

⁴ Factual issues exist about the value of the Property and the unresolved Debtors’ objection as to the amount of the United States’ claim from the Chapter 13 case. doc. 94 at 4. *See also* doc. 62 (Debtor’s objection to the proof of claim of the United States). However, these issues need not be resolved to address the present exemption issue.

1986). A party objecting to a claim of exemption “has the burden of proving that the exemptions are not properly claimed.” Fed. R. Bankr. P. 4003(c).

To begin, the court accepts the general principle espoused in *Hibbard* that a Chapter 7 trustee cannot distribute assets determined exempt on behalf of a DSO creditor based upon the statutory authority in § 522(c). But applying that principle to the question of the Debtors’ rights to a homestead exemption against the United States holding a statutory assessment lien is another matter. *Hibbard* involved assets for which exemption rights already had been determined. The *Hibbard* decision found that once exemption rights had been determined, property was removed from the bankruptcy estate and a chapter 7 trustee lacked authority to distribute the asset. As this decision will explain, the United States’ rights to collect against any otherwise exempt proceeds of property is allowed by the intersection of § 522(c) of the Bankruptcy Code and, unlike *Hibbard*, the United States’ particular rights under federal tax law. See *United States v. Safeco Ins. Co. of Am., Inc.*, 870 F.3d 338, 340 (6th Cir. 1989) (“[S]tate-law interpretations upon the ability of general creditors to reach a taxpayer’s property do not affect the attachment of federal tax liens because the state-law consequences flowing from a property interest properly defined under state law are of no concern to the operation of federal tax law.”) (internal quotation marks and citation omitted). In *Hibbard*, these types of questions were not at issue because the DSO creditor did not assert any competing rights under state or federal law beyond the singular argument of how § 522(c) was to be interpreted.

Specifically, the United States asserts a statutory assessment lien under 26 U.S.C. § 6321⁵ on the Property, although, excepting the small secured claim, it does not have a separate recorded

⁵ Section 6321 states:

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notice of its lien. This broad, statutory lien in § 6321 applies to all of the Debtors' property. *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 720 (1985) (quoting *Glass City Bank v. United States*, 326 U.S. 265, 267 (1945) ("Stronger language could hardly have been selected to reveal a purpose to assure the collection of taxes."); *See Am. Trust v. Am. Cmty. Mut. Ins. Co.*, 142 F.3d 920, 925 (6th Cir. 1998) ("[Section 6321] exempts certain property from a levy but not from a lien, and we decline to alter this allocation.").

The United States recognizes that this unrecorded statutory lien is not valid against the Trustee due to the Trustee's status as a hypothetical bona fide purchaser under 11 U.S.C. § 544(a)(3) and 26 U.S.C. § 6323(a)⁶ and therefore, the Trustee is within his statutory authority to sell the Property. *See United States v. Speers*, 382 U.S. 266 (1965) (holding, under the Bankruptcy Act, that a statutory assessment lien is invalid against a trustee unless recorded, due to the trustee's status under § 70c, the predecessor to § 544(a)). However, the strong arm powers do not reach the Debtors' exemption and the United States' right to collect against that exempt property under § 522(c). *In re Duncan*, 406 B.R. 904, 909 (Bankr. D. Mont. 2009) (citing *United States v. Rogers*, 461 U.S. 677, 697 (1983)) ("[S]tate homestead laws do not protect a debtor from the imposition of a federal tax lien on the debtor's interest.").

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

26 U.S.C. § 6321.

⁶ 26 U.S.C. § 6323(a) states: "The lien imposed by section 6321 shall not be valid against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary."

Therefore, the statutory lien of the United States would attach to the proceeds of any future sale of the Property by the Trustee. The United States further recognizes that the lien applies to the exempt assets because some or all of these taxes are non-dischargeable.⁷ Because this is an unrecorded statutory assessment lien, § 522(c)(2)(B) does not apply. *See* 11 U.S.C. § 522(c)(2)(B) (referring to “a tax lien, notice of which is properly filed”). Compare *United States v. Rogers*, 558 F. Supp. 2d 774, 788 (N.D. Ohio 2008) (court noted § 522(c)(2)(B) requires notice of a federal tax lien to be filed to attach to property of the estate exempted by the debtor, but was not addressing the separate exception for non-dischargeable debt under § 522(c)(1)).

The court agrees with the United States that to the extent any portion of its claim is non-dischargeable, the Trustee could sell the Property to pay that portion of the proceeds that the United States may attach pursuant to § 522(c)(1) and 26 U.S.C. § 6321. The final distribution of the proceeds of the Property after any sale, including discussions of a possible carve-out for other creditors of this estate is not presently before the court. Moreover, absent a determination otherwise, § 523(a)(1) is self-executing. *See United States v. Ellsworth (In re Ellsworth)*, 158 B.R. 856 (M.D. Fla. 1993) (discharge injunction did not prevent the I.R.S. from collecting tax debt post-discharge and the failure of the government to file a dischargeability complaint does not affect the debt’s dischargeability). Therefore, the case as it presently stands allows the United States to pursue its rights under § 522(c)(1) to reach all the proceeds of the homestead, despite the Debtors’ state law homestead exemption. *See In re Clate*, 69 B.R. 506, 510 (Bankr. W.D. Pa. 1987) (“We therefore find that the Debtor remains liable to the IRS for \$6,236.67, which sum is non-dischargeable, and

⁷ The Debtors stated in an earlier filing in this case that they “do not dispute that that are personally liable for the trust fund taxes....” doc. 50 at 2.

that the \$5,000.00 [homestead] exemption claimed by the Debtor similarly remains liable to the IRS.”).

Nevertheless, the Debtors have asserted, even if *Hibbard* is distinguishable, the Trustee is prohibited from selling the property due to the operation of 26 U.S.C. § 6334(e)(1), which states:

(e) Levy allowed on principal residences and certain business assets in certain circumstances.—

(1) Principal residences.--

(A) Approval required.--A principal residence shall not be exempt from levy if a judge or magistrate of a district court of the United States approves (in writing) the levy of such residence.

(B) Jurisdiction.--The district courts of the United States shall have exclusive jurisdiction to approve a levy under subparagraph (A).

Since the United States District Court has not approved a sale of the Property, the Debtors claim this bankruptcy court lacks subject matter jurisdiction pursuant to § 6334(e). However, this court agrees with the United States that § 6334(e) only applies to seizure of a residence by the United States. *Hollar v. Meyers (In re Hollar)*, 184 B.R. 243, 250 (Bankr. M.D.N.C. 1995). In this instance, the United States would receive funds from any sale by the Trustee pursuant to the attachment of those assets by virtue of its statutory lien. Section 6334(e) does not prohibit such a sale or attachment. As the United States noted, such a prohibition would effectively eliminate the ability of trustees to sell property subject to a federal tax lien. *See also In re Reeves*, No. 10-02562-8-SWH, 2011 WL 841238, at *3 (Bankr. E.D.N.C. Mar. 8, 2011), *aff'd sub nom. Reeves v. Callaway*, No. 5:11-CV-280-F, 2012 WL 10180780 (E.D.N.C. Aug. 14, 2012), *aff'd* 546 F. App'x 235 (4th Cir. 2013) (26 U.S.C. § 6344(a)(13) restricts the IRS from levy and sale, but not a Chapter

7 trustee). While § 6334 limits the ability of the United States to levy upon exempt property, such exemptions do not affect the statutory lien of the United States.

As a final argument, the Debtors take the position that the United States, excepting the small secured claim of \$5053.50, has filed an unsecured proof of claim and therefore cannot assert a secured status as piercing the homestead exemption for any potential sale because it waived that status. The Debtors cite to *Salyersville Nat'l Bank v. Bailey (In re Bailey)*, 664 F.3d 1026 (6th Cir. 2011) in support of their argument. In *Bailey*, chapter 7 debtors enter into a reaffirmation agreement with their lender that had a mortgage on real property and a lien on the debtor's truck. The reaffirmation agreement was found unenforceable under state law because the bank had filed an unsecured claim and found to have waived its secured status.

However, the United States did not waive its secured status against the proceeds of any future sale of the Debtors' homestead. Instead, it filed a largely unsecured proof of claim that recognized its un-recorded statutory assessment liens pursuant to § 6321 did not provide the United States secured status against the trustee's rights to the Property (or any other estate property). As explained earlier, this is because, pursuant to I.R.C. § 6433(a), assessment liens granted to the United States by § 6321 are not valid against a purchaser, and pursuant to § 544(a)(3) of the Bankruptcy Code, the Trustee has the status of a hypothetical bona fide purchaser. Nevertheless, although the United States cannot assert a secured claim against the Property itself, it may enforce the assessment lien against the proceeds of such a sale, despite the Debtors' homestead exemption, and despite such proceeds being exempt against other creditors. *Duncan*, 406 B.R. at 909; *In re Pletz*, 225 B.R. 206, 208 (Bankr. D. Or. 1997) (“[A] federal tax lien [pursuant to § 6321] attaches on assessment to all of the property of the taxpayer, even property that is exempt under state and

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Case 3:15-bk-33218 Doc 98 Filed 12/27/16 Entered 12/27/16 15:47:45 Desc Main Document Page 11 of 11

bankruptcy law.”); *Bernstein v. Pavich (In re Pavich)*, 191 B.R. 838, 847 (Bankr. E.D. Cal. 1996) (determining exemption laws do not protect property from the enforcement of federal tax liens, citing §§ 522(c)(1) and 522(c)(2)(B)); *Prince v. I.R.S.*, Case No. 09-43627 AFC, 2016 WL 2962669, at *3 (E.D. Tex. May 23, 2016) (“[T]he Texas homestead exemption has no effect on a federal tax lien.”).

Conclusion

For all these reasons, the United States’ objection to the Debtors’ homestead exemption is sustained.

IT IS SO ORDERED.

Copies to:

Default List +
Bradley Sarnell, U.S. Department of Justice, PO Box 55, Washington, D.C., 20044

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In re Blasingame, 709 Fed.Appx. 363 (2018)

709 Fed.Appx. 363
 This case was not selected for publication in West's Federal Reporter. See Fed. Rule of Appellate Procedure 32.1 generally governing citation of judicial decisions issued on or after Jan. 1, 2007. See also U.S.Ct. of App. 6th Cir. Rule 32.1. United States Court of Appeals, Sixth Circuit.

IN RE Earl Bernard BLASINGAME;
 Margaret Gooch Blasingame **Debtors**.
 Church Joint Venture, L.P., Plaintiff-Appellant,
 v.
 Martin A. Grusin, Respondent-Appellee.

Case No. 16-6776
 |
 Filed January 04, 2018

Synopsis

Background: Motion was filed for award of sanctions, inter alia, against **attorney** who represented Chapter 7 **debtors** in pending garnishment and debt collection action, and who referred **debtors** to local **bankruptcy** counsel to file Chapter 7 petition on their behalf. The United States **Bankruptcy** Court for the Western District of Tennessee, Jennie D. Latta, J., entered order awarding sanctions against this **attorney**, both pursuant to **Bankruptcy** Rule 9011 or on “unreasonable and vexatious multiplication” theory, and **attorney** appealed. The **Bankruptcy** Appellate Panel (BAP), C. Kathryn Preston, Chief Judge, 559 B.R. 676, vacated sanctions award, and movant appealed.

Holdings: The Court of Appeals, Damon J. Keith, Circuit Judge, held that:

[1] absent evidence that **attorney** in question, as opposed to **debtors'** retained **bankruptcy** counsel, filed the petition, **attorney's** conduct did not fall within the exception to Rule 9011's “safe harbor” provision for “the filing of a petition”;

[2] mere fact that **attorney** in question allegedly “exerted influence over the content of the filed petition” did not bring his conduct within the subject exception to the “safe harbor” provision; and

[3] **attorney** in question did not “vexatiously and unreasonably multiply” the proceedings.

Bankruptcy court's decision vacated and reversed; BAP's decision affirmed.

West Headnotes (3)

[1] **Bankruptcy**

⇨ Frivolity or bad faith;sanctions

Absent evidence that **attorney** who represented Chapter 7 **debtors** in pending garnishment and debt collection action and who referred them to local **bankruptcy** counsel to file Chapter 7 petition on their behalf actually filed the **bankruptcy** petition, his conduct did not fall within the exception to Rule 9011's “safe harbor” provision for “the filing of a petition”; **debtors'** **bankruptcy** counsel, the **attorney** of record in the **bankruptcy** proceeding, accepted full responsibility for filing of petition and information included in accompanying **bankruptcy** schedules and statement of financial affairs (SOFA) documents, and, in response to questioning concerning his reliance on garnishment **attorney's** opinion or advice with respect to whether certain trusts needed to be disclosed in the schedules, **bankruptcy** counsel testified that he himself made that decision, such that there was no support for contention that garnishment **attorney**, as opposed to **bankruptcy** counsel, filed petition. Fed. R. Bankr. P. 9011, 9011(c) (1)(A).

Cases that cite this headnote

[2] **Bankruptcy**

⇨ Frivolity or bad faith;sanctions

Mere fact that **attorney** who represented Chapter 7 **debtors** in pending garnishment and debt collection action and who referred them to local **bankruptcy** counsel to file Chapter 7 petition on their behalf allegedly “exerted influence over the content of the filed

In re Blasingame, 709 Fed.Appx. 363 (2018)

petition,” which was actually filed by **debtors'** **bankruptcy** counsel, who was the **attorney** of record in the **bankruptcy** proceeding, did not bring conduct of garnishment **attorney** within the exception to Rule 9011's “safe harbor” provision for “the filing of a petition.” Fed. R. Bankr. P. 9011, 9011(c)(1)(A).

Cases that cite this headnote

[3] **Bankruptcy**

⇨ Frivolity or bad faith;sanctions

Attorney who represented Chapter 7 **debtors** in pending garnishment and debt collection action and who referred them to local **bankruptcy** counsel to file Chapter 7 petition on their behalf did not “vexatiously and unreasonably multiply” the **bankruptcy** proceedings, so as to warrant imposition of sanctions, by filing two motions and accompanying affidavits; filing of the subject motions and affidavits did not rise to the level of frivolity, garnishment **attorney** did not engage in bad-faith misconduct but, rather, his actual involvement in the litigation process was most aptly described as a good-faith, yet unknowledgeable, provision of legal advice to **debtors** who were represented by experienced counsel, given that his substantive position as to whether assets held in spendthrift trusts had to be disclosed in **bankruptcy** was not entirely unsupported in caselaw, and negligence or incompetence alone was not enough to warrant imposition of sanctions under the subject statute. 28 U.S.C.A. § 1927.

Cases that cite this headnote

***364 ON APPEAL FROM THE BANKRUPTCY APPELLATE PANEL OF THE SIXTH CIRCUIT**

Attorneys and Law Firms

Bruce W. Akerly, Malone Akerly Martin, Dallas, TX, for Appellant

Edward Michael Bearman, Gary E. Veazey, Law Office, Memphis, TN, for Appellee

BEFORE: KEITH, McKEAGUE and STRANCH, Circuit Judges.

OPINION

DAMON J. KEITH, Circuit Judge.

This appeal arises from a judgment entered by the Sixth Circuit **Bankruptcy** Appellate Panel (“Panel”) on November 7, 2016, vacating sanctions imposed against Appellee Martin Grusin by the U.S. **Bankruptcy** Court for the Western District of Tennessee on July 16, 2014.¹ On appeal, the Panel concluded that the **bankruptcy** court erred in imposing sanctions under Federal Rule of **Bankruptcy** Procedure 9011 (“Rule 9011”) because Appellant Church Joint Venture, L.P. (“Church”) failed to comply with the “safe harbor” provision of the Rule and Appellee’s actions did not fall within Rule 9011(c) (1)(A)’s narrow exception for “the filing of a petition in violation of subdivision (b).” The Panel also concluded that ***365** the **bankruptcy** court erred in imposing sanctions under 28 U.S.C. § 1927 because the factual record did not support a finding that Grusin vexatiously and unreasonably multiplied the proceedings.

On appeal from the Panel’s decision, Appellant Church alleges that the Panel erred in vacating the order imposing sanctions under Rule 9011 and 28 U.S.C. § 1927. Independently reviewing the decision of the **bankruptcy** court for error, we vacate and reverse the **bankruptcy** court’s decision and affirm the decision of the Panel.

I.

In July and August of 2008, **Debtors** Earl and Margaret Blasingame sought advice from their long-time acquaintance Martin Grusin regarding a “financial crisis” they encountered in 2008 after garnishment proceedings were initiated by Church. **Debtors** explained that the majority of their assets were held in family trusts and Grusin advised **Debtors** that “assets belonging to the trusts or corporations would not be reachable by the **Debtors'** personal creditors under Tennessee [t]rust law.” Prudently, Grusin also advised **Debtors** that he was not an expert in **bankruptcy** law, nor was he qualified to file a **bankruptcy** petition on their behalf, and subsequently introduced **Debtors** to Tommy L. Fullen, an experienced

In re Blasingame, 709 Fed.Appx. 363 (2018)

bankruptcy attorney in the Memphis area. Fullen, who was retained by Debtors to represent them during the bankruptcy proceedings, filed the Chapter 7 petition on Debtors' behalf on August 15, 2008.

During discovery, Church and the appointed Trustee determined that several trusts and other assets possessed by Debtors as co-trustees were not disclosed in the schedules and statement of financial affairs ("SOFA") filed with the initial petition.² Church, as creditor and the party of interest in the underlying litigation, along with another creditor and the Trustee subsequently filed an adversary complaint objecting to Debtors' discharge and alleging claims of fraudulent concealment, *inter alia*. Church filed a Motion for Partial Summary Judgment of Discharge Issues, to which Appellee Grusin and Joseph T. Townsend, an attorney affiliated in some capacity with the Law Offices of Tommy L. Fullen, filed a joint response on behalf of their respective clients. On February 22, 2011, the bankruptcy court granted Church's motion and denied Debtors' petition for discharge due to their violations of 11 U.S.C. § 727(a)(4) and (5) for failure to disclose the totality of their trust income and other assets.

On March 8, 2011, Townsend, on behalf of Fullen's office, filed a Motion to Alter or Amend Judgment, accompanied by two affidavits, signed by Grusin and Fullen, respectively, which explained that Debtors' failure to disclose the entirety of their trusts and assets was, in large part, the result of reliance on information provided by Grusin and Fullen regarding the inclusion of trusts in the bankruptcy estate. The bankruptcy court denied the aforementioned motion. During the pendency of the court's determination of the Motion to Alter or Amend Judgment, Church filed a Motion to Disqualify both Fullen and Grusin as counsel for Debtors and the related entities.³ The bankruptcy court granted *366 the motion.⁴

In July and August of 2012, the bankruptcy court held evidentiary hearings on Debtors' Motion for Relief from Judgment under Federal Rule of Civil Procedure 60(b), filed by Debtors' newly retained counsel, David Cocke. Following the evidentiary proceedings, during which Grusin testified regarding the advice he provided to Debtors, the bankruptcy court entered a provisional order granting the motion but directed Debtors that they must obtain a remand from the Panel before a final judgment

could be entered. *See In re Blasingame*, 559 B.R. at 681 n.8. Upon remand from the Panel, on April 8, 2013, the bankruptcy court entered a Final Order Granting the Motion for Relief of Judgment. *Id.* Following the bankruptcy court's order granting relief from judgment, the parties proceeded to trial on the discharge action.

On March 31, 2014, Church filed its Motion for Sanctions against Fullen and Grusin, alleging violations of Federal Rule of Bankruptcy Procedure 9011 and 28 U.S.C. § 1927. A hearing on the motion was held on May 21, 2014, during which Church offered evidence in support of its contention that Fullen and Grusin were negligent in their handling of the underlying proceedings and requested payment of attorney fees, costs and expenses associated with various stages of the proceedings, specifically the Rule 2004 proceedings, and filings responsive to Debtors' Response to the Motion for Partial Summary Judgment, the Motion to Alter or Amend Judgment, and the Motion for Relief from Judgment.⁵ At the conclusion of the motion hearing, the bankruptcy court ordered the parties to provide "references to testimony in the court's record regarding the circumstances under which the chapter 7 petition was filed" and evidentiary support for the amount of monetary sanctions requested. On July 16, 2014, after receipt of the requested supplementation, the bankruptcy court entered an Order Granting Motion for Sanctions, ordering Grusin to disgorge any fees paid or funds transferred to him by Debtors, pay \$20,000 to the Trustee and complete fifteen hours of continuing legal education training, pursuant to Rule 9011. Additionally, Grusin was ordered to pay Church and the Trustee an additional amount in fees and expenses pursuant to Section 1927, which was later set at a total of almost \$75,000 in the bankruptcy court's Amended Order Setting Amounts of Additional Sanctions, entered on August 4, 2014. Grusin subsequently appealed the Order Granting Church's Motion for Sanctions to the Panel. On November 7, 2016, the Panel vacated the bankruptcy court's orders imposing sanctions against Grusin. Church now seeks review of the Panel's decision.

II.

This court independently reviews the underlying decision of the bankruptcy court when the decision has been appealed to the Bankruptcy Appellate Panel. *See *367 B-Line, LLC v. Wingerter (In re Wingerter)*, 594 F.3d

In re Blasingame, 709 Fed.Appx. 363 (2018)

931, 935 (6th Cir. 2010) (citing *Tidewater Fin. Co. v. Curry* (*In re Curry*), 509 F.3d 735, 735 (6th Cir. 2007)). We review the **bankruptcy** “court’s sanctions award for an abuse of discretion, its factual findings for clear error, and its conclusions of law de novo.” *Grossman v. Wehrle* (*In re Royal Manor Mgmt., Inc.*), 652 Fed.Appx. 330, 337 (6th Cir. 2016) (internal citations omitted).

“An abuse of discretion is defined as a definite and firm conviction that the court below committed a clear error of judgment.” *Barlow v. M.J. Waterman & Assocs.* (*In re M.J. Waterman & Assocs.*), 227 F.3d 604, 607–08 (6th Cir. 2000) (internal quotation marks, brackets, and citations omitted); see also *Cooter & Gell v. Hartmarx Corp.*, 496 U.S. 384, 401, 110 S.Ct. 2447, 110 L.Ed.2d 359 (1990) (“When an appellate court reviews a [lower] court’s factual findings, the abuse-of-discretion and clearly erroneous standards are indistinguishable: A court of appeals would be justified in concluding that a district court had abused its discretion in making a factual finding only if the finding were clearly erroneous.”).

III.

On appeal, Church challenges the Panel’s determination to vacate the **bankruptcy** court’s imposition of sanctions under both Federal Rule of **Bankruptcy** Procedure 9011 and 28 U.S.C. § 1927. We address each issue in turn.

A.

The **bankruptcy** court found that Grusin’s role as “shadow” counsel in advising **Debtors** Earl and Margaret Blasingame that they need not include certain asset disclosures in their prospective **bankruptcy** petition warranted the imposition of sanctions under Rule 9011. Federal Rule of **Bankruptcy** Procedure 9011 provides, in relevant part:

(b) Representations to the court. By presenting to the court (whether by signing, filing, submitting, or later advocating) a petition, pleading, written motion, or other paper, an **attorney** or unrepresented party is certifying that to the best of the person’s knowledge, information, and belief, formed after an inquiry reasonable under the circumstances,—

(1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;

(2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;

(3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and

(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

(c) Sanctions. If, after notice and a reasonable opportunity to respond, the court determines that subdivision (b) has been violated, the court may, subject to the conditions stated below, impose an appropriate sanction upon the **attorneys**, law firms, or parties that have violated subdivision (b) or are responsible for the violation.

(1) How Initiated.

(A) By Motion. A motion for sanctions under this rule shall be made separately from other motions or *368 requests and shall describe the specific conduct alleged to violate subdivision (b). It shall be served as provided in Rule 7004. The motion for sanctions may not be filed with or presented to the court unless, within 21 days after service of the motion (or such other period as the court may prescribe), the challenged paper, claim, defense, contention, allegation, or denial is not withdrawn or appropriately corrected, *except that this limitation shall not apply if the conduct alleged is the filing of a petition in violation of subdivision (b)*. If warranted, the court may award to the party prevailing on the motion the reasonable expenses and **attorney’s** fees incurred in presenting or opposing the motion.

Fed. R. Bankr. P. 9011 (emphasis added).

In re Blasingame, 709 Fed.Appx. 363 (2018)

The **bankruptcy** court noted that while it acknowledged Church's failure to comply with the 21-day safe harbor provision of Rule 9011, Grusin's "shadow representation of the **Debtors**," which included involvement in drafting the **bankruptcy** schedules and SOFA documents and later advocating for them, subjected him to sanctions under Rule 9011(c)(1)(A)'s exception for his involvement in the filing of the petition. On appeal, the Panel rejected the **bankruptcy** court's analysis and concluded that because evidence in the record demonstrated that Fullen, as retained counsel for **Debtors**, filed the petition, rather than Grusin, the exception outlined in Rule 9011(c)(1)(A) was inapplicable to Grusin's alleged misconduct.

Church argues that the Panel erred in vacating the decision of the **bankruptcy** court and contends that Rule 9011 permits the court to sanction "even the party who influences filing of the **bankruptcy** petition," conceding that it failed to comply with the 21-day safe harbor provision and that sanctions under Rule 9011 would only be applicable to Grusin under the narrow exception provided for "filing of a petition."

In opposition, Appellee contends that the **bankruptcy** court abused its discretion by imposing sanctions based on a clearly erroneous factual finding that he was responsible for the initial filings in the **bankruptcy** petition. Appellee further contends that the **bankruptcy** court erroneously applied Rule 9011's safe harbor provision and abused its discretion by granting Church's requested sanctions well after it disposed of motions which allegedly gave rise to the Rule 9011 violation.

Church's primary contention in support of the **bankruptcy** court's decision is that the sanctions provided for in Rule 9011 apply not only to **attorneys** of record, but to any party, **attorney** or law firm that violates subdivision (b) of the Rule. This argument, however, is improperly focused on the actor rather than the alleged misconduct. Had Church complied with the safe harbor provision, a requisite precondition to filing most motions for sanctions, perhaps a discussion regarding sanctionable parties under Rule 9011 would be appropriate. However, here, Church has failed to comply with the safe harbor provision; therefore, we look directly to the conduct contemplated in Rule 9011(c)(1)(A) to determine whether Grusin's conduct falls within this narrow exception to the safe harbor provision.

The exception states that only where the "conduct alleged is the filing of a petition," can a motion for sanctions be filed or presented to the court without first complying with the 21-day safe harbor provision. Fed. R. Bankr. P. 9011(c)(1)(A). Church asserts that as "the de facto **attorney**" for **Debtors**, Grusin was responsible for the errors contained in the filed petition, *369 and that his actions fits squarely within the conduct contemplated and sought to be deterred by Rule 9011.

[1] Upon review of the record, there is no evidence to support a finding that Grusin filed the petition. What is evident from the record is Fullen's acceptance of full responsibility for the filing of the petition and the information included in the accompanying schedules and SOFA documents. In his affidavit filed in support of the Motion to Alter or Amend Judgment, Fullen stated: "I represent the **Debtors**, Earl Bernard Blasingame and Margaret Gooch Blasingame. I met with them and prepared the **bankruptcy** petition, schedules and statement of affairs for them to file." During direct examination at the discharge proceedings, Fullen went on to testify, "I made that decision," in response to questioning concerning his reliance on Grusin's opinion or advice with respect to whether the trusts needed to be disclosed in the **bankruptcy** schedules. In light of these representations, we find no support for the contention that Grusin filed the petition, under the plain reading of the Rule.

[2] Alternatively, Church asserts that Grusin "exerted influence over the content of the filed petition," which positioned him as the party *responsible* for the filing of the petition, even if he did not directly file the petition himself. As noted in the case before the Panel, Church has failed to cite any legal authority indicating that conduct other than the filing of the petition falls within Rule 9011(c)(1)(A)'s exception to the safe harbor provision. Nor can we find support for that position upon independent review. Under certain circumstances, an individual who orchestrated or masterminded a frivolous or bad-faith filing but did not sign it properly may be sanctioned under Rule 9011. See, e.g., *Schwartz v. Kujawa*, 270 F.3d 578 (8th Cir. 2001) (approving the award of **attorney's** fees as a Rule 9011 sanction against an **attorney** who did not sign the petition but "helped to identify creditors, provided some details about [the **debtor's**] financial dealings, and may have assisted ... in preparing" an involuntary petition filed against a former client); *In re Evergreen Sec., Ltd.*, 384 B.R. 882, 930 (Bankr. M.D. Fla. 2008), *aff'd*, 391 B.R.

In re Blasingame, 709 Fed.Appx. 363 (2018)

184 (M.D. Fla. 2008), *aff'd*, 570 F.3d 1257 (11th Cir. 2009) (“An attorney may be sanctioned pursuant to Rule 9011 even though the attorney did not sign the paper but orchestrated its filing.”). But these cases do not interpret the scope of the safe harbor exception, and we decline to expand their reach. Even if they were relevant, these cases do not go so far as to hold that merely “exert[ing] an undeniable influence” over the Debtors and their attorney or “clearly affect[ing] the filing”—the conduct alleged here—is sufficient to justify sanctions.

Irrespective of Grusin’s continued involvement in the underlying bankruptcy proceedings, the record reflects that Fullen, as counsel of record and signatory to the petition, was the party responsible for filing the petition. Without evidentiary support or legal authority placing Grusin’s conduct within the purview of Rule 9011(c)(1) (A), the bankruptcy court erred in finding that Grusin’s conduct fell within the narrow exception. Thus, without an applicable exception, the bankruptcy court abused its discretion by granting Church’s motion for sanctions under Rule 9011 where Church failed to comply with the safe harbor provision. *See Penn, LLC v. Prosper Bus. Dev. Corp.*, 773 F.3d 764, 767 (6th Cir. 2014) (holding that parties’ failure to comply with the safe harbor provision of Rule 9011’s counterpart in the civil context, Rule 11 of the Federal Rules of Civil Procedure, will result in a denial of a motion for sanctions); *370 *Ridder v. City of Springfield*, 109 F.3d 288, 296 (6th Cir. 1997) (same).

B.

[3] Next, Church challenges the Panel’s determination that the bankruptcy court erred in finding that Grusin’s filing of two motions and accompanying affidavits “vexatiously and unreasonably multiplied the proceedings,” warranting sanctions under 28 U.S.C. § 1927 (“Section 1927”).⁶ Section 1927 states:

Any attorney or other person admitted to conduct cases in any court of the United States ... who so multiplies the proceedings in any case unreasonably and vexatiously may be required by the court to satisfy personally the excess costs, expenses, and attorneys’ fees

reasonably incurred because of such conduct.

The Sixth Circuit standard for imposing sanctions under Section 1927 was established in *Jones v. Continental Corp.*, and provides that:

28 U.S.C. § 1927 authorizes a court to assess fees against an attorney for “unreasonable and vexatious” multiplication of litigation despite the absence of any conscious impropriety.... Accordingly, at least when an attorney knows or reasonably should know that a claim pursued is frivolous, or that his or her litigation tactics will needlessly obstruct the litigation of nonfrivolous claims, a trial court does not err by assessing fees attributable to such actions against the attorney.

789 F.2d 1225, 1230 (6th Cir. 1986).⁷

The imposition of sanctions pursuant to Section 1927 “require[s] a showing of something less than subjective bad faith, but something more than negligence or incompetence. Thus, an attorney is sanctionable when he intentionally abuses the judicial process or knowingly disregards the risk that his actions will needlessly multiply proceedings.” *Red Carpet Studios Div. of Source Advantage, Ltd. v. Sater*, 465 F.3d 642, 646 (6th Cir. 2006) (citations omitted). “Bad faith is not required to support a sanction under § 1927.” *Garner v. Cuyahoga Cty. Juvenile Court*, 554 F.3d 624, 645 (6th Cir. 2009) (quoting *Wilson-Simmons v. Lake Cty. Sheriff’s Dep’t*, 207 F.3d 818, 824 (6th Cir. 2000)).

The bankruptcy court found that, as a result of Grusin’s involvement during the adversary proceedings, “numerous [Bankruptcy Rule] 2004 examinations were required,” “Plaintiffs and the court were put to unnecessary effort and expense,” and “litigation concerning the Debtors’ discharge was made necessary as the direct result of the errors and omissions in Debtors’ schedules and statement of financial affairs.”⁸ Accordingly, the bankruptcy court found that sanctions pursuant to Section 1927 were appropriate to compensate

In re Blasingame, 709 Fed.Appx. 363 (2018)

*371 Church and the Trustee for attorneys' fees and costs incurred as a result of: (1) the Response to the Motion for Partial Summary Judgment; (2) the Motion to Alter or Amend Judgment, and the corresponding affidavits of Grusin and Fullen; and (3) any filings made in response to Appellee's Motion for Relief from Judgment, filed by newly retained counsel, excluding the Motion to Disqualify.

Upon review of the bankruptcy court's decision, the Panel concluded that the evidence supporting the bankruptcy court's justification for imposing sanctions against Grusin was insufficient. First, it found that the filing of the two motions, and the attached affidavits, did not rise to the level of frivolity which typically establishes grounds for sanctions under Section 1927. Moreover, in applying the appropriate standard, the Panel noted that the record was devoid of any finding by the bankruptcy court that the motions were presented before the court in bad faith or that Grusin knew or reasonably should have known that the motions were frivolous. In fact, Grusin maintained the accuracy of the instruction given throughout the proceedings until the discharge hearing. Nevertheless, Church argues that Grusin knew or should have known that his inaccurate instruction and erroneous advice would unreasonably or vexatiously multiply the proceedings.

At the outset, one might presume that the involvement of an admittedly unqualified lawyer in a rather complex bankruptcy matter typifies the sort of misconduct contemplated by Section 1927. However, upon closer examination of Grusin's actual involvement in the litigation process, the record reflects that his conduct is most aptly described as a good faith, yet unknowledgeable, provision of legal advice to individuals who were represented by experienced counsel. First, the bankruptcy court found (albeit not in the context of Section 1927) that Grusin's "conduct falls short of subjective bad faith," and we will defer to that finding of

fact. Second, Grusin's substantive position—that assets held in spendthrift trusts and corporations are not part of the bankruptcy estate and so need not be disclosed—is not entirely unsupported in caselaw. See *In re Lucas*, 924 F.2d 597, 600 (6th Cir. 1991) ("[P]roperty of a debtor falling within the definition of this exception [for a valid spendthrift trust] is excluded from the bankruptcy estate."); see also *Vaugh v. Aboukhater (In re Aboukhater)*, 165 B.R. 904, 910–11 (9th Cir. BAP 1994) ("Non-estate property need not be disclosed in the debtor's schedules."). Third, there is no indication in the record that Grusin continued to advise the Debtors against disclosure after the bankruptcy court held that his legal position was incorrect.

As this court articulated in *Red Carpet Studios*, negligence or incompetence alone is not enough to warrant the imposition of sanctions under Section 1927. In accord with the Panel's decision, we find the underlying record insufficient to support the bankruptcy court's finding that Grusin's conduct—filing the aforementioned motions—was frivolous, or that the filing of these responsive motions unreasonably or vexatiously multiplied the proceedings, particularly where Debtors' counsel claimed full responsibility for filing the defective petition and schedules that initiated the discharge proceedings and the bankruptcy court found that at least some of those proceedings most likely would have ensued with or without Grusin's involvement in the case.⁹

*372 IV.

For the foregoing reasons, the decision of the Panel to vacate the bankruptcy court's imposition of sanctions is affirmed.

All Citations

709 Fed.Appx. 363

Footnotes

1 The bankruptcy court granted Church's motion for sanctions as to Grusin pursuant to Federal Rule of Bankruptcy Procedure 9011 and 29 U.S.C. § 1927, but did not specify the exact amount of the monetary sanction imposed. The bankruptcy court subsequently ordered the parties to supplement the record with a sufficient description of the monetary amount requested. On August 1, 2014, the bankruptcy court entered an Order Setting Amounts of Additional Sanctions, setting the monetary amount of the sanctions imposed. This Order was later amended. See *In re Blasingame*, 559 B.R. 676, 683 (6th Cir. BAP 2016).

In re Blasingame, 709 Fed.Appx. 363 (2018)

- 2 Appellee Grusin represented the non-**debtor** entities at the discharge phase of the proceedings.
- 3 The motion also referenced Grusin and Fullen's firms, presumably a reference to Townsend, who filed **Debtors'** Response to the Motion for Partial Summary Judgment on Fullen's behalf. The response was also signed by Grusin. See *In re Blasingame*, 559 B.R. at 680 n.6.
- 4 On January 30, 2012, the **bankruptcy** court granted Church's Motion for Derivative Standing, allowing Church to bring a **malpractice** action against Grusin and Fullen.
- 5 Church also requested that Fullen and Grusin be ordered to
disgorge all fees and/or property received from **Debtors** for legal services related to the case, attend 25 hours of ethics courses, provide 40 hours of *pro bono* work and make a \$5,000 donation to a local *pro bono* or legal services organization or program ... [and] that Fullen and Grusin be banned from practicing law in the **bankruptcy** court for the Western District of Tennessee and be referred to the State Bar of Tennessee for additional discipline.
In re Blasingame, 559 B.R. at 682.
- 6 Church also sought sanctions pursuant to the court's "inherent power" to impose sanctions for abuse of the litigation proceedings. The **bankruptcy** court did not rely on its inherent power to impose sanctions against Appellee Grusin or Fullen.
- 7 While no published decision of this court addresses the question of whether **bankruptcy** courts are "court[s] of the United States" for the purposes of Section 1927, the parties have not raised the issue here. We therefore follow this court's practice in a series of unpublished decisions and assume such sanctions are available. See *Grossman*, 652 Fed.Appx. at 341-42; *Followell v. Mills*, 317 Fed.Appx. 501, 513-14 (6th Cir. 2009); *Maloolf v. Level Propane Gasses, Inc.*, 316 Fed.Appx. 373, 376-77 (6th Cir. 2008) (per curiam).
- 8 The **bankruptcy** court noted later in its order that the **Bankruptcy** Rule 2004 examinations would have likely been conducted irrespective of Appellee Grusin's involvement in the proceedings.
- 9 Because the imposition of sanctions was erroneous under both Rule 9011 and Section 1927, we do not reach Appellee's claims regarding the excessiveness of the monetary amount imposed or the timeliness of the imposition of sanctions.

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NOT FOR PUBLICATION

United States District Court,
D. New Jersey.

IN RE Teresa GUIDICE, Debtor
John Sywilok, Trustee, and Teresa
Guidice, Debtor, Appellees,
and
James A. Kridel, Jr., Appellant.

Civil Action No.: 16-9444 (JLL)

Signed 06/12/2017

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OPINION

JOSE L. LINARES, UNITED STATES DISTRICT
JUDGE

*1 This matter comes before the Court by way of Appellant James A. Kridel, Jr.'s Notice of Appeal of the Bankruptcy Court's Order Approving Settlement and Order Partially Granting Motion to Intervene. (ECF No. 1). Appellees John Sywilok ("Trustee") and Teresa Guidice ("Debtor") have submitted an opposition to the appeal, (ECF No. 6), which Appellant has replied to (ECF No. 11). The Court has considered the parties' submissions and decides this matter without oral argument pursuant to Rule 78 of the Federal Rules of Civil Procedure. For the reasons set forth below, the Court denies the Appellant's Bankruptcy Appeal and affirms the Bankruptcy Court.

BACKGROUND¹

On July 28, 2015, Debtor filed a Complaint in the Superior Court of New Jersey alleging that Appellant committed malpractice in the legal representation of Debtor. (*See* Bankr. No. 09-39032 ("Bankruptcy Action"), ECF No. 180-3 at ¶¶ 1-2). Namely, Appellant was negligent in the preparation and amendments of Debtor's Chapter 7 bankruptcy petition. (*See id.* at ¶¶ 88-161). Debtor's Complaint alleges that on June 30, 2010, Trustee filed a complaint in Bankruptcy Court objecting to Debtor's Chapter 7 bankruptcy discharge. (*Id.* at ¶ 178). The Trustee's three count complaint alleged various concealments and falsities made before and during the Debtor's petition for Bankruptcy. (*Id.* at ¶¶ 179-81). Debtor alleges in the state Court action Trustee's complaint was the result of Appellant's negligence. (*Id.* at ¶ 182).

In March of 2011, while the action between Debtor and Trustee was pending, Debtor became the subject of a federal grand jury investigation for mortgage and bankruptcy fraud. (*Id.* at ¶¶ 207, 209). Debtor alleges that in relation to the investigation, Appellant concealed conversations with the United States Government, and failed to explain the import of a "Target Letter" or advise her of the necessity to retain a criminal defense attorney. (*Id.* at ¶¶ 207-12). On December 15, 2011, Debtor waived her bankruptcy discharge, asserting that the waiver was inevitable due to Appellant's negligence. (*Id.* at ¶ 255). Ultimately on March 4, 2014, Debtor pled guilty, and on October 2, 2014, Debtor was sentenced to fifteen months of incarceration. (*Id.* at ¶¶ 296-97). Debtor alleges that her incarceration was the result of Appellant's negligent legal representation of her. (*Id.* at ¶ 4).

On April 29, 2016, Trustee moved to reopen the Bankruptcy Action after learning of the above Malpractice Action. (*See* Bankruptcy Action, ECF No. 177). Trustee's motion was successful, and the Bankruptcy Action was reopened before Judge Meisel. (*See* Bankruptcy Action, ECF No. 188). On July 12, 2016, Debtor requested that the parties be sent to mediation due to a dispute between Trustee and Debtor as to the ownership of the claims in the Malpractice Action. (*See* Bankruptcy Action, ECF No. 211). Judge Meisel ordered the parties to participate in mediation and appointed Judge Joel Pisano, U.S.D.J. (ret.) as the mediator. (*See* Bankruptcy Action, ECF No 225).

*2 On October 5, 2016, the parties reached a settlement. (See Bankruptcy Action, ECF No. 240). As a part of the settlement, Debtor was entitled to 55% of the net proceeds from the Malpractice Action and her Bankruptcy Estate would receive the remaining 45%. (Id.). The portion assigned to the Bankruptcy Estate would be distributed in due course by Trustee and pursuant to the Bankruptcy Code. (Id.). On November 1, 2016, Trustee submitted a Motion to the Bankruptcy Court to approve the settlement, on notice to Appellant as well as to all Debtor's creditors. (See Bankruptcy Action, ECF Nos. 240–242). No creditor filed an objection to Trustee's Motion. (See generally Bankruptcy Action).

On November 22, 2016, Appellant filed an Objection to Trustee's Motion as well as a Cross-Motion to intervene in the Bankruptcy Action. (See Bankruptcy Action, ECF No. 249). The Bankruptcy Court partially granted Appellant's Motion to Intervene for the sole purpose of hearing him with regards to the issue of a conflict of interest between counsel for Debtor and Trustee, Mr. Carlos J. Cuevas, Esq., and the law firm of Brach Eichler, LLC, respectively. (See Bankruptcy Action, ECF No. 257). Thereafter, Judge Meisel ruled that Appellant lacked standing to challenge the settlement. (See Bankruptcy Action December 6, 2016 Transcript (“Dec. 6 Tr.”) 24:9–15). In so ruling, Judge Meisel cited *Whitemore v. Arkansas*, 495 U.S. 149 (1990), which stands for the premise that “a party seeking Constitutional standing must demonstrate an injury in fact that is concrete, distinct and palpable and actual or imminent.” (Id. 20:2–6). Furthermore, Judge Meisel noted that in a Bankruptcy case, a party seeking standing must be a party-in-interest as articulated in *In re Global Industrial Technologies, Inc.*, 645 F.3d 201, 210 (3d Cir. 2011). (Id. 20:4–16). Judge Meisel believed that Appellant did not meet the Constitutional requirement for standing because Appellant failed to show any injury that would result from the settlement agreement between Trustee and Debtor. (Id. 24:5–6).

Additionally, the Bankruptcy Court ruled that Appellant had standing to be heard on the conflict of interest issue because based on the intent of *In re Congoleum*, 46 F.3d 675 (3d Cir. 2005), attorneys have a responsibility to apprise the court of potential ethical violations. (See id. 22:3–22). On the issue of whether there was a conflict of interest between counsel for Debtor and Trustee, Judge Meisel acknowledged that previous to the proceeding the

parties took “diametrically opposed positions as to what was property of the estate and what wasn't property of the estate, namely, the cause of action.” (Id. 32:9–12). Nevertheless, Judge Meisel believed that if she approved the settlement agreement, then the parties' interests would align into one, which would be to successfully pursue the Malpractice Action against Appellant. (Id. 32:14–20). After ruling that the parties did not hold an adverse interest in violation of the New Jersey Code of Professional Conduct Rule 1.7, the Bankruptcy Court analyzed the contours of 11 U.S.C. § 327(e). (Id. 34:5–15). The Bankruptcy Court ruled that the retention was not in violation of 11 U.S.C. § 327(e) because it was for a particular purpose and the retained attorney's do not “need to show that they're disinterested[.]” parties. (Id.).

Thereafter, the Bankruptcy Court heard argument on the issue of the settlement. (See id. 34:35, 35:1–2). At that point, Appellant attempted to be heard on the issue of the settlement agreement, but Judge Meisel reasserted her limited grant of standing. (See id. 43:4–10). Judge Meisel only permitted Appellant to be heard on the issue of the settlement agreement to raise it as an example of the alleged conflict of interest. (See id. 43:11–13). Accordingly, the Bankruptcy Court did not consider that argument as part of the approval of the settlement but rather considered the settlement under the factors set forth under *In re Martin*, 91 F3d 389 (3d Cir. 1996). (See Bankruptcy Action December 9, 2016 Transcript 22:12–18). The Bankruptcy Court ultimately approved the settlement, finding that it was fair and equitable, and that it further did not constitute an improper assignment of a tort claim. (See Bankruptcy Action, ECF No. 261). That same Order also found that “[t]he 14 day stay contained in Federal Rule of Bankruptcy Procedure 4001(a)(3) is inapplicable.” (See id.). Thus, the Malpractice Action was allowed to proceed in due course.

*3 Appellant now appeals the decisions of the Bankruptcy Court to grant only partial intervention and to approve the settlement. (Bankruptcy Action, ECF No. 262 at 2). Specifically, Appellant asserts four errors. (ECF No. 3 at 2). First, Appellant challenges the Bankruptcy Court's failure to determine the ownership of the Malpractice Action. (Id.). Second, Appellant claims that the Bankruptcy Court erred in vacating the stay in state court on the Malpractice Action. (Id.).² Third, Appellant challenges the determination of the Bankruptcy Court that there was no conflict of interest

between counsel for Debtor and Trustee. (Id.). Fourth, Appellant challenges the determination of the Bankruptcy Court that the settlement was not an assignment of the Malpractice Action from Trustee to Debtor. (Id.).

For the reasons set forth below, this Court only analyzes the issues of standing and the conflict of interest, and affirms Judge Meisel's rulings.

LEGAL STANDARD

I. Standard of Review

A district court reviews a bankruptcy court's legal conclusions under *de novo* review. *See In re Global Industrial Technologies, Inc.*, 645 F.3d 201, 209 (3d Cir. 2011). "A court's decision regarding standing is a legal conclusion subject to *de novo* review." *Id.* The disqualification of a law firm is reviewed for an abuse of discretion. *See In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 470 (3d Cir. 1998). An abuse of discretion is a deferential standard, and reversal requires this court to find that the decision of the bankruptcy court rested on "a clearly erroneous finding of fact, an errant conclusion of law or an improper application of law to fact." *In re Nutraquest*, 434 F.3d 639, 645 (3d Cir. 2006).

II. Standing

To intervene in a bankruptcy action, a party must have at the minimum constitutional standing. *See In re Global Industrial Technologies, Inc.*, 645 F.3d 201, 210 (3d Cir. 2011). Constitutional standing exists where a party shows that the party has suffered an injury-in-fact. *Whitmore v. Arkansas*, 495 U.S. 149, 155 (1990). An injury-in-fact "must be concrete in both a qualitative and temporal sense." *Id.* In addition, an alleged injury "must be distinct and palpable, as opposed to merely abstract, and the alleged harm must be actual or imminent, not conjectural or hypothetical." *Id.* Moreover, an alleged injury "need not be financial and only need[s] to be fairly traceable to the alleged illegal action." *In re Congoleum Corp.*, 426 F.3d 675, 685 (3d Cir. 2005). Indeed, a favorable decision must be likely to cure the alleged injury. *Whitmore v. Arkansas*, 495 U.S. 149, 155 (1990). "The contours of the injury-in-fact requirement, while not precisely defined, are very generous." *Bowman v. Wilson*, 672, F.2d 1145, 1151 (3d Cir. 1982).

In a bankruptcy proceeding, a party seeking standing must be a party-in-interest as stated under 11 U.S.C. § 1109(b). *See* 11 U.S.C. § 1109 (b); *In re Global Industrial Technologies, Inc.*, 645 F.3d 201, 210–11 (3d Cir. 2011). Nevertheless, the requirement of a party-in-interest must be "construed broadly" as "effectively coextensive" with constitutional standing. *See In re Global Industrial Technologies, Inc.*, 645 F.3d 201, 211 (3d Cir. 2011). Therefore, the appropriate test for standing in a bankruptcy proceeding is the injury-in-fact requirement. *Id.* at 210. Of course, "[a] party denied standing to sue, or to intervene, or to object, may obviously appeal such a determination." *See In re Pittsburgh & Lake Erie R.R. Co. & Sec. & Antitrust Litig.*, 543 F.2d 1058, 1064 (3d Cir. 1976).

Further, the New Jersey Constitution provides that "[t]he Superior Court shall have original general jurisdiction throughout the State in all causes." *See* N.J. Const. Art. VI, § 3, ¶ 2. This broad grant of jurisdiction, however, may be limited by the Supremacy Clause of the United States Constitution. *See* U.S. Const. Art. VI, cl. 2. Therefore, where the United States Congress grants to the federal courts the exclusive jurisdiction over a certain subject-matter, then a state court cannot practice jurisdiction over that subject-matter. *See Gulf Offshore Co. v. Mobil Oil Corp.*, 454 U.S. 473, 478 (1981).

*4 Moreover, unless otherwise provided, "the district courts shall have exclusive jurisdiction of all cases under title 11." *See* 28 U.S.C. § 1334(a). Chapter 7 bankruptcy actions fall under title 11 of the United States Code. *See* 11 U.S.C. §§ 301–66. Nevertheless, where a state legal malpractice claim is based on an alleged error in a bankruptcy action under the exclusive jurisdiction of the federal courts, then that does not necessitate the practice of exclusive jurisdiction over the state legal malpractice claim. *See Gunn v. Minton*, 133 S.Ct. 1059, 1065 (2013) (holding state legal malpractice claim based on alleged error in patent proceeding does not fall under exclusive jurisdiction); *Laures v. Wolf Haldenstein Adler Freeman & Herz, L.L.P.*, 2015 WL 10434722, *5. The question is whether the state legal malpractice claim falls under title 11 of the United States Code. *See Gunn v. Minton*, 133 S.Ct. 1059, 1064 (2013). Nowhere under title 11 of the United States Code provides for such an interpretation. *See generally* 11 U.S.C. §§ 301–66. Moreover, where a cause of action, like a state legal malpractice claim, is the property of the estate, there is no indication that Chapter

7 of the Bankruptcy Code confers exclusive jurisdiction to the federal courts over those causes of action. *See generally* 11 U.S.C. §§ 301–66.

III. Conflict of Interest

Under the New Jersey Code of Professional Conduct Rule 1.7, “a lawyer shall not represent a client if the representation involves a concurrent conflict of interest.” *See* N.J. Rules of Prof 1 Conduct (“N.J. Rules”) R. 1.7(a). A concurrent conflict of interest exists under two circumstances. (*See id.*) First, it exists where “the representation of one client will be directly adverse to another client[.]” *See* N.J. Rules R. 1.7(a)(1). Second, it exists where “there is a significant risk that the representation of one or more clients will be materially limited by the lawyer’s responsibilities to another client, a former client, or a third person or by a personal interest of the lawyer.” *See* N.J. Rules R. 1.7(a)(2). Notwithstanding, the affected parties to a concurrent conflict of interest may waive the concurrent conflict of interest. *See* N.J. Rules R. 1.7(b).

Moreover, in bankruptcy court, 11 U.S.C. § 327(e) provides that a trustee “may employ, for a specified special purpose, ... an attorney that has represented the debtor, if in the best interest of the estate,” and if there is no conflict of interest between the attorney and the debtor or estate. *See* 11 U.S.C. § 327(e). Unlike 11 U.S.C. § 327(a), § 327(e) does not have a requirement that the employed attorney be a disinterested person. *See In re Congoleum Corp.*, 426 F.3d 675, 688–89 (3d Cir. 2005).

ANALYSIS

I. Appellant Lacks Standing to Challenge the Settlement Agreement

Appellant’s challenges the Bankruptcy Court’s failure to determine the ownership of the Malpractice Action, decision to vacate the stay in state court on the Malpractice Action, and determination that the settlement was not an assignment of a tort claim. These three challenges rest on the validity of the settlement agreement. Therefore, for Appellant to win, this Court must first decide that Appellant has standing to challenge the approval of the settlement agreement. If this Court finds that Appellant has standing, then second, this Court must decide that the approval of the settlement agreement was

an abuse of discretion. Appellant fails from the outset. This is because Appellant has failed to show that the approval of the settlement agreement caused an injury-in-fact to Appellant, even by the liberal injury-in-fact standard. Assuming, arguendo, that Judge Meisel erred in approving the settlement agreement, Appellant suffers no injury from this.

Appellant argues that he has standing because if the Malpractice Action belongs exclusively to the estate, then New Jersey Superior Court does not have subject matter jurisdiction. (*See* ECF No. 11 at 3). Appellant claims that the settlement agreement between Debtor and Trustee impermissibly conferred subject matter jurisdiction to the New Jersey state court, and because “[he] has personal assets [] at stake in the [state court] lawsuit,” he suffers injury and thus has standing. (*Id.* at 4). This assertion requires the Appellant to first prove that the approval of the settlement agreement conferred subject matter jurisdiction on the New Jersey Superior Court. Second, Appellate must prove that conferring subject matter jurisdiction on the New Jersey Superior Court is an injury-in-fact sufficient to give rise to standing. Appellant fails to meet the first element thereby making analysis of the second element unnecessary.

*5 Debtor filed the Malpractice Action against Appellant in the New Jersey Superior Court, (*see generally* Bankruptcy Action, ECF No. 180–3), which is a Court of general and concurrent jurisdiction. Although the alleged Malpractice Action is based on Appellant’s alleged malpractice in a Chapter 7 bankruptcy proceeding, (*see id.* at ¶¶ 1, 2), and Chapter 7 bankruptcy actions are under the exclusive jurisdiction of the federal courts, (*see* 28 U.S.C. § 1334(a)), a legal malpractice claim is not under the exclusive jurisdiction of the federal courts. *See Gunn v. Minton*, 133 S.Ct. 1059, 1065 (2013). Moreover, even if the Malpractice Action belongs exclusively to the estate, there is no law that Appellant cites to that would indicate that Trustee cannot independently bring suit in the New Jersey Superior Court based on the alleged malpractice.

Appellant, in his reply, relies on *Laures v. Wolf Haldenstein Adler Freeman & Herz, L.L.P.*, 2015 WL 10434722 (2005), for the proposition that the New Jersey Superior Court will not practice jurisdiction over a malpractice claim if it stems from a case under the exclusive jurisdiction of the federal courts. (ECF No. 11 at 5–6). *Laures*, however, does not stand

for such a proposition. *See generally Laures v. Wolf Haldenstein Adler Freeman & Herz, L.L.P.*, 2015 WL 10434722. Rather, *Laures* recognized that “[n]o one can seriously dispute that such expansive authority [of a State Court] includes the authority to resolve legal malpractice claims[.]” even where those claims stem from cases under the exclusive jurisdiction of the federal courts. *Id.* at *5. Although Appellant is correct that the court *Laures* reversed the lower Court for the practice of jurisdiction, that reversal was based on an order from United States District Court for the Eastern District of Michigan retaining exclusive jurisdiction over all matters relating to the action in that case. *See id.* Indeed, “under the doctrine of comity[,] the Law Division should have declined to hear the action until plaintiff first sought relief in the federal court.” *Id.* at *6.

Here, there is no order from the Bankruptcy Court retaining exclusive jurisdiction over all matters relating to the Bankruptcy Estate. (*See generally* Bankruptcy Action). Rather, the Bankruptcy Court found that “[t]he 14 day stay contained in Federal Rule of Bankruptcy Procedure 4001(a)(3) is inapplicable” thus indicating that it would not practice exclusive jurisdiction over the Malpractice Action. (*See* Bankruptcy Action, ECF No. 261). Based on the aforementioned analysis, Appellant lacks standing to challenge the settlement agreement. Thus, Appellant cannot challenge the Bankruptcy Court’s failure to determine the ownership of the Malpractice Action, decision to vacate the stay in state court on the Malpractice Action, and determination that the settlement was not an assignment of a tort claim.

II. Counsel for Debtor and Trustee Are Not Under a Conflict of Interest

Appellant asserts that the Bankruptcy Court erred in its determination that there was no conflict of interest between counsel for Debtor and Trustee, Mr. Carlos J. Cuevas, Esq., and the law firm of Brach Eichler, LLC, respectively. (*See* ECF No. 3 at 2). For reversal, Appellant must prove that it was an abuse of discretion for the Bankruptcy Court to so order. *See In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 470 (3d Cir. 1998). Appellant argues that there is a conflict of interest between counsel for Debtor and Trustee “by virtue ... [of] the positions they have advocated and continue to advocate” (*See* ECF No. 3 at 21). It is true that Debtor and Trustee have opposed one another up until the settlement and have specifically litigated the reopening

of the Bankruptcy Action and the ownership of the Malpractice Action. (*See* ECF No. 3 at 21–24). Appellant further argues that, contrary to Judge Meisel’s belief that the settlement agreement aligned the parties’ interests, there is still a conflict of interest because the ownership of the Malpractice Action is left unresolved, which will cause later litigation that is not in the best interest of the estate. (*See id.* at 24). This Court does not determine whether that is true or not, but assuming it is, Appellant fails to explain how 11 U.S.C. § 327(e) does not resolve this potential issue.

*6 Under 11 U.S.C. § 327(e), counsel for Debtor and Trustee are only employed for the “specified special purpose” to prosecute the Malpractice Action. *See* 11 U.S.C. § 327(e); Bankruptcy Action, ECF No. 261. Debtor and Trustee only have one interest in the Malpractice Action, which is to be successful in prosecution. Even if Appellant is correct, that the ownership of the Malpractice Action is left unresolved, the pending Malpractice Action in the New Jersey Superior Court has no bearing on the actual ownership of the Malpractice Action. That issue, if later litigated, would be for the Bankruptcy Court to determine, and counsel for Debtor and Trustee are not retained for both parties in the Bankruptcy Action. Therefore, counsel for Debtor and Trustee, the subject attorney and law firm, do not hold an adverse interest to either Debtor or Trustee and thus do not violate New Jersey Code of Professional Conduct Rule 1.7 or 11 U.S.C. § 327(e).

In addition, the slight disparity the net proceeds to Debtor and Trustee in the settlement agreement, i.e., 55% of the net proceeds going to Debtor and 45% of the net proceeds going to Debtor’s Bankruptcy Estate, is not in violation of 11 U.S.C. § 327(e). This is because 11 U.S.C. § 327(e) does not have a requirement that the employed attorney be a disinterested person. (*See* 11 U.S.C. § 327(e); *In re Congoleum Corp.*, 426 F.3d 675, 688–89 (3d Cir. 2005)). Therefore, the Bankruptcy Court did not abuse its discretion in its determination that counsel for Debtor and Trustee, Mr. Carlos J. Cuevas, Esq., and the law firm of Brach Eichler, LLC, do not have a conflict of interest.

CONCLUSION

For the reasons above, the Court denies the Appellant’s Bankruptcy Appeal and affirms the Bankruptcy Court

2018 MIDWEST REGIONAL BANKRUPTCY SEMINAR

In re Guidice, Slip Copy (2017)

on all issues. An appropriate Order accompanies this
Opinion.

All Citations

Slip Copy, 2017 WL 2539397

Footnotes

- 1 This background is derived from the Bankruptcy Record which the parties have designated and submitted to this Court. (ECF Nos. 2, 5).
- 2 This issue has already been disposed of by this Court's Order and Opinion dated May 1, 2017. (ECF Nos. 18, 19).

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