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Focus

Professionals Learn From ‘Movitz’ That Disclosure Rules Always Rule

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On April 28, the Bankruptcy Appellate Panel for the 9th U.S. Circuit Court of Appeals issued an opinion holding that any professional subject to a “facially plausible” preference claim — no matter how small the amount at issue — may be ineligible for employment or compensation by the debtor’s bankruptcy estate unless the Bankruptcy Court first determines that the claim is without merit or the payment is first returned. *Movitz v. Baker (In re Triple Star Welding)*, 324 B.R. 788 (2005).

A facially plausible preference claim exists whenever, during the 90 days before the bankruptcy case commenced and while the debtor was insolvent, (a) the debtor paid the professional on account of an antecedent debt and (b) this payment was more than the professional would have received in a liquidation. 11 U.S.C. Section 547(b).

In *Movitz*, the debtor, with the assistance of counsel, had arranged for the sale of substantially all of its assets to a corporation formed by two of the debtor’s three principals and its comptroller. The debtor started a Chapter 11 bankruptcy case and, as is common practice, obtained authority from the Bankruptcy Court to employ the same attorney that it used previously.

Although counsel initially represented to the bankruptcy court that the debtor was seeking authority to enter into the sale agreement that it had negotiated, it ultimately came to light that the sale had been consummated before the bankruptcy case began. The purchaser made no

payments to the debtor and began its own Chapter 11 case. The debtor’s case was converted to Chapter 7, and a Chapter 7 trustee was appointed.

When the debtor’s counsel submitted his final fee application for approval, the Chapter 7 trustee objected on the basis that counsel was not disinterested, as required by 11 U.S.C. Section 327(a), principally because (a) counsel had been a key player in the allegedly fraudulent transfer of the debtor’s assets to the newly formed corporation and (b) he had received allegedly preferential payments on account of his pre-bankruptcy services.

The bankruptcy court stated that it could not determine the preference issues without a separate adversary action, dismissed the trustee’s concerns about the transfer of assets, and awarded debtor’s counsel his requested fees and costs over the trustee’s objection. An appeal to the bankruptcy appellate panel ensued.

The panel expressed considerable concern regarding the lack of disclosure by the debtor’s counsel, whose limited disclosures were “characterized by a lack of timeliness, completeness, and candor.” In particular, the panel remarked on counsel’s failure to provide full disclosures regarding the sale transaction, his receipt of potentially preferential payments, and his treatment of his pre-bankruptcy claims against the debtor.

Counsel also had failed to ensure that the debtor signed the application to employ counsel (thereby creating a failure of disclosure on the part of the debtor, as well). Remarking that it was premature to excuse counsel’s

nondisclosure or to award him compensation until the true facts were known, the panel remanded the matter to the bankruptcy court for a further determination regarding the factual issues.

The panel also specifically addressed the trustee’s assertion that debtor’s counsel was not disinterested and therefore was not entitled to compensation from the estate, because he had received allegedly preferential payments from the debtor. Citing the 3rd U.S. Circuit Court of Appeal’s decision in *Staiano v. Pillowtex Inc. (In re Pillowtex Inc.)*, 304 F.3d 246 (2002), the panel held that a bankruptcy court is required to make a determination regarding any alleged preferences received by a professional before approving the professional’s employment or compensation.

If an adversary proceeding is required to evaluate these issues fully, the bankruptcy court must either defer its consideration of the professional’s application until resolution of the adversary proceeding or combine the two proceedings.

Movitz likely will be even broader in its application than the 3rd Circuit’s decision in *Pillowtex*. The *Pillowtex* rule provides that preference claims must be resolved before employment of professionals when the claims are both “facially plausible” and “substantial.” In *Movitz*, the panel adopted the first prong of this standard while rejecting the second. Instead, the panel held that “a professional can be ineligible for employment even if the alleged preference was not in a substantial dollar amount.” The panel’s statement is underscored by the facts of the case: The

potential preference at issue was between \$1,000 and \$5,000.

Fully litigating every potential preference claim involving an estate professional before employment, in many instances, is likely to be unworkable or uneconomical. Alternatively, a professional who has received facially plausible preference payments might nevertheless be able to avoid running afoul of *Movitz* by returning those payments to the debtor — or perhaps agreeing to a holdback in the amount of the prepetition payments — and waiving any resulting prepetition claim. *Movitz*.

To be effective, the return of the payments probably must be unconditional and must be accomplished before the employment of the professional. In *Pillowtex*, the 3rd Circuit held that it was insufficient for a professional merely to promise to return any amounts ultimately determined to be preferential, given that the professional was unlikely to ensure that the preference claim against it was pursued.

The panel adopted the 3rd Circuit's

reasoning, stating that the preference determination must be made before employment is approved and noting that a professional "would probably be ineligible for employment, no matter how completely he disclosed the relevant facts, at least until he returns the preference."

This statement highlights another important aspect of *Movitz*: its emphasis on full, prompt disclosures of all connections with the debtor, creditors and parties in interest, no matter how trivial those connections may seem. As the panel stated, it published its opinion "to stress to the bar the importance of full and timely disclosure of pertinent facts, and compliance with all procedural rules, as part of the employment and compensation of professionals in bankruptcy cases."

Failure to comply with disclosure rules — even inadvertently — is itself a sanctionable violation. This is true even if full disclosure would establish that the professional has not violated any other

bankruptcy-related statute and even if the bankruptcy estate suffers no harm. In short, to avoid running afoul of *Movitz*, professionals who have received facially plausible preference payments from a debtor and who are seeking employment in connection with a debtor's bankruptcy case pending in the 9th Circuit should disclose fully those potential preferences and recognize that any inadequate disclosures might result in sanctions and denial of employment.

Moreover, before that professional's employment may be approved by the bankruptcy court, the professional must either fully defend against the preference claims or otherwise resolve them in such a way as to alleviate any issues regarding the professional's disinterestedness.

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