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Committee Officers

Upcoming Events

Contribute to the Newsletter

ABI World

Newsletter Archives

Seeking Sanctions? Consisder the Timing and Recovery

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Many cases have dealt with bankruptcy petitions filed in "bad faith." Typically, a party in interest seeks to simply have the petition dismissed, and seeks no further relief. Infrequently, however, a party may make the difficult decision to seek the imposition of sanctions against a bad faith filer and his or her counsel to deter future abuse of the Bankruptcy Code. This article discusses two recent examples of these situations and some lessons should you ever be charged with the unenviable task of requesting sanctions against opposing counsel.

In re Schaefer Salt Recovery Inc. [1]

Schaefer Salt Recovery (SSR) filed a bare-bones chapter 11 petition in the Bankruptcy Court for the District of New Jersey within eight days of its formation. SSR's only assets were mortgages on three properties that were facing tax-lien foreclosures. The court granted a motion to dismiss, finding that the petition had been filed in "bad faith," but struck language in the proposed order that would have barred SSR from filing another petition for six months. Two months later, SSR filed a chapter 7 petition. SSR's vice president and counsel informed the court of his consent to a dismissal at a subsequent hearing. Once more, SSR was kicked out of the bankruptcy court.

Nine days later, opposing counsel moved for costs and attorneys' fees under Rule 9011 against SSR and its counsel. The bankruptcy court heard arguments and awarded attorneys' fees and costs as sanctions for the successive frivolous petitions. However, the bankruptcy court questioned whether Rule 9011 applied, because the matter was already adjudicated. Instead, an award of costs and attorneys' fees was granted under 28 U.S.C. § 1927.

Attorneys' fees and costs are recoverable under § 1927 if the court finds that an attorney has multiplied proceedings in an unreasonable and vexatious manner, thereby increasing the cost of the proceedings, and done so in bad faith or by intentional misconduct. Similar to Rule 9011, the purpose of awarding costs and fees under § 1927 is the deterrence of intentional and unnecessary delay in the proceedings.

The bankruptcy court had concerns about the post-dismissal applicability of Rule 9011, which ultimately led it to reconsider the award under § 1927, and in a subsequent opinion and order, it declined to enforce payment. It reasoned that a motion for sanctions made after the entry of a final judgment, the chapter 7 dismissal, was untimely under the "supervisory rule." The supervisory rule provides that motions under Rule 11 of the Federal Rules of Civil Procedure (FRCP) must be filed in a district court before entry of a final judgment. The bankruptcy court concluded Rule 9011 sanctions sought nine days after dismissal were untimely, and awarding fees and costs under § 1927 would be viewed in the same way by the Third Circuit. Accordingly, it concluded the motion for sanctions under Rule 9011, or fees and costs under § 1927, was untimely and had to be overturned.

On appeal, the Third Circuit did not specifically extend the application of the supervisory rule to sanctions under Rule 9011. The appellate court noted that district and bankruptcy courts had already ruled that the supervisory rule applied in the Third Circuit. The court concluded that it did not have to rule on this issue, given the facts of the case, for two reasons. First, under the supervisory rule, a district court retains the power to adjudicate sanctions after final judgment *if* there is a notice of appeal. Second, a district court may impose sanctions under FRCP 11 after a final judgment if the final judgment at issue is a *voluntary* dismissal. [2]

The Third Circuit reasoned that allowing courts to impose post-judgment sanctions was necessary to prevent a "wily plaintiff" from filing baseless complaints, sapping the resources of its adversaries and the court, only to be insulated from sanctions by promptly filing a voluntary dismissal. Rule 9011 proscribes the same conduct as FRCP 11. [3] Accordingly, if baseless filings are to be deterred, Rule 9011 should be available after a petition is voluntarily dismissed.

The Third Circuit also discussed Rule 9011's safe harbor. A motion for sanctions under Rule 9011 cannot be filed unless the allegedly offending party fails to correct its actions within 21 days of being served with the motion, which is also available in FRCP 11. [4] Recognizing the uniqueness of bankruptcy proceedings, Congress excluded the safe-harbor provision when the offensive filing is a bankruptcy petition. This exception evidences a concern that a party subject to the automatic stay would be forced to choose between seeking sanctions, which would require a 21-day wait, or immediately filing a motion to dismiss a bad faith petition. Finally, the Third Circuit turned to whether a bankruptcy court was competent to award fees and costs under § 1927 after a final judgment. The appellate court addressed two issues in this regard.

The first issue was whether the supervisory rule applied to § 1927. The Third Circuit determined that this rule was inappropriate under § 1927 because an award under this section is "normally" only determined when a case is over. [5] As the purpose of § 1927 is to compensate for excessive fees and costs that result from an abusive expansion of litigation, a determination about what constituted "excessive" fees and costs could only be decided at the conclusion of the proceedings.

The second issue was whether a bankruptcy court was "a court of the United States" under § 1927 such that it could rely on its grant of authority to award costs and fees. The Third Circuit noted that a number of its sister circuits had refused to extend such authority to a bankruptcy court. [6] It ultimately refused to follow those circuits' guidance, and ruled that the bankruptcy court had the power to issue a § 1927 award.

In re Currency Management Company Ltd. [7]

Currency Management Company Ltd. was involved in a state-court proceeding wherein Matt's Landscaping Contractors Ltd. (MLC) sought payment for snow-removal services. Because of discovery violations by Currency's counsel, the state court entered an order barring Currency from calling witnesses or introducing evidence at trial. Not long thereafter, Currency filed for chapter 7 in the Bankruptcy Court for the Northern District of Illinois.

MLC moved for sanctions against Currency's counsel for abusing the bankruptcy process and filing "false" and "malicious" proofs of claims. On the first charge, MLC argued that Currency's bankruptcy filing was an abuse of the bankruptcy process, as it was filed with the intention of circumventing the state court's order barring Currency's counsel from introducing any evidence with respect to the parties' underlying claim disputes. With respect to the second charge, MLC contended that the filing of three of the proofs of claims by Currency's counsel was on behalf of other law firms where she previously practiced. Each of those proofs of claim was disallowed upon the objection of the chapter 7 trustee. While MLC requested sanctions on these grounds, it did not move to have Currency's bankruptcy case dismissed.

The bankruptcy court ruled that Currency's bankruptcy petition was filed in bad faith to avoid adverse results in another forum and that sanctions against Currency's counsel would be appropriate. Filing the proofs of claims did not warrant sanctions, as Currency's counsel filed the proofs of claims for the sake of full disclosure with the belief that those claims were due for payment. [8]

After determining that sanctions were warranted, the court then considered the amount of sanctions to be awarded. The court imposed a sanction to be paid to counsel for MLC as *partial* reimbursement for attorney's fees incurred as a result of the bankruptcy. [9] This award was based on the fact that MLC spent too much time arguing about Currency's counsel's filing of proofs of claim, which the court ultimately ruled was not subject to a penalty. Accordingly, MLC would only recover the reasonable fees for bringing a motion to modify the stay to pursue its claims in state court (which motion was granted) and responding to Currency's objection to its claim.

The *Currency* court also questioned the wisdom of MLC's decision not to pursue dismissal of the petition as well, suggesting that had MLC sought dismissal, the court's sanctions likely would have required Currency's bankruptcy counsel to pay the administrative costs incurred in Currency's bankruptcy case. [10] Had Currency's counsel been required to pay those administrative-priority expenses, MLC's prospects for recovery on its claim against Currency would have been enhanced. Because MLC was apparently "content" with letting the case proceed, the bankruptcy court did not penalize Currency's attorney for administrative costs.

Conclusion

Both of these cases provide lessons for the bankruptcy practitioner that is in the unfortunate position of having to seek sanctions against opposing counsel. *Schaefer Salt Recovery* shows the applicability of the "supervisory rule" in bankruptcy cases and warns about the time constraints that may apply to Rule 9011 motions. The case is also instructive about the availability of sanctions under other applicable statutes and rules—such as § 1927—in situations where Bankruptcy Rule 9011 is not an option. Finally, the opinion holds that bad faith petitions are not subject to Rule 9011's 21-day safe harbor and that sanctions for a bad faith filing and the dismissal of the bad faith case can be sought simultaneously in appropriate circumstances. *Currency Management* suggests that, in bad faith bankruptcy cases, seeking dismissal of the underlying case should be one's primary focus instead of pursuing sanctions for the bad faith filing and that the failure to request dismissal of the case may adversely affect the amount of sanctions the court might award to the moving party.

1. 542 F.3d 90 (3d Cir. 2008).

2. *Id.* at 98.

3. *Id.* at 99.

4. *Id.*

5. *Id.* at 102.

6. *Id.* at 103-04.

7. No. 09 B 03825, 2010 WL 3523086 (Bankr. N.D. Ill. Sept. 3, 2010).

8. *See id.* at *5, 7.

9. *Id.* at *10.

10. *Id.*