UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

EAGLE ROCK DAIRYS, INC. — CASE NO. 92-63813

Debtor — Chapter 11

IN RE:

WILLIAM MICHAEL BARGABOS — CASE NO. 92-63812
CHRISTINE D. BARGABOS — Chapter 11

Debtors — Jointly Administered Case

APPEARANCES:

MENTER, RUDIN & TRIVELPIECE, P.C. — MITCHELL KATZ, ESQ. Of Counsel
500 South Salina Street
Syracuse, New York l3202

SHAW, LICITRA, ESERNIO, SCHWARTZ, & PARENTE, ESQS. — STUART GORDON, ESQ. Of Counsel
Attorneys for Debtor
1010 Franklin Ave.
Garden City, New York 11530

HANCOCK & ESTABROOK, ESQS. — STEPHEN DONATO, ESQ. Of Counsel
Attorneys for Agway
MONY Tower I
P.O. Box 4938
Syracuse, New York 13202

MICHAEL COLLINS, ESQ.
Office of U.S. Trustee
10 Broad Street
Utica, New York 13501

HISCOCK & BARCLAY, ESQS. — ERIC CHARLTON, ESQ. Of Counsel
Attorneys For Key Bank
Financial Plaza
P.O. 4878
Syracuse, New York 13221

Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW AND ORDER

On January 17, 1995, the Court heard oral argument on the

Third Amended and Final Application For Allowance of Menter, Rudin & Trivelpiece, P.C. ("Menter") in the case of Eagle Rock Dairys, Inc. ("Eagle Rock") as well as on the Final Application For Allowance of Menter in the case of William Michael Bargabos and Christine D. Bargabos ("Bargabos").

The Eagle Rock case and the Bargabos case are being jointly administered pursuant to an Order of this Court dated March 15, 1993. Both cases were voluntarily filed on December 16, 1992, pursuant to Chapter 11 of the Bankruptcy Code (11 U.S.C. §§101-1330) ("Code").

Menter was appointed as counsel to both Debtors by Orders dated December 22, 1992, which made its appointment effective December 16, 1992.

Prior to oral argument, objections to both Final Applications were filed by the United States Trustee ("UST"), as well as by the Debtor William Michael Bargabos ("W.M.Bargabos"). Menter replied to the objections and both Menter and the UST filed memoranda of law. The Court directed that the parties advise it of their request for an evidentiary hearing. Thereafter, all parties advised the Court that they waived an evidentiary hearing and the objectants agreed that they would accept an affidavit of Peter L. Hubbard, Esq., a shareholder in Menter, sworn to the 24th of January 1995 ("Hubbard Affidavit"), in lieu of an evidentiary hearing.[1] The contested matters were submitted for decision on

[1] It is noted that the UST waived its right to an evidentiary hearing upon the condition that Menter file the Hubbard Affidavit with the Court. On January 27, 1995, Menter provided the Court with a copy of that Affidavit. To date the original affidavit has not been filed.

February 2, 1995.

Pursuant to an Order of this Court dated January 4, 1995, Menter withdrew as counsel to Bargabos and Eagle Rock, effective January 3, 1995. Substitute counsel has been appointed in both cases.

JURISDICTIONAL STATEMENT

The Court has core jurisdiction of these contested matters pursuant to 28 U.S.C. §§1334(b), 157(a), (b)(1) and (2)(A).

FACTS

As indicated, Menter was appointed as counsel to both Eagle Rock and Bargabos by Orders of this Court dated December 22, 1992 ("Appointment Orders"). In the Affirmations filed by Menter in support of the Appointment Orders, it alleged that it "represents no interest adverse to the Debtors or their estate in matters upon which Menter is to be engaged." (See Menter Affirmation filed in Bargabos case, dated December 15, 1992, at ¶3 and Menter Affirmation filed in Eagle Rock case dated December 15, 1992 at ¶3.

On or about December 14, 1994, the Menter firm, in a supplemental Affidavit filed with this Court, acknowledged that it had represented both Telmark Inc. ("Telmark") and Agway, Inc.

("Agway")[2]. Both Telmark and, arguably, Agway were creditors of Eagle Rock at the time it filed its Chapter 11 case or at some point subsequent thereto.[3] Menter did not disclose its representation of these creditors in its Affirmation in support of the Appointment Orders or at any later time prior to December 14, 1994.

Similarly, Menter represented Syracuse Supply Company ("SSC"), a creditor of Bargabos, simultaneously with its representation of these Debtors in their Chapter 11 case. Menter did not disclose that representation prior to filing the December 14, 1994 Supplemental Affidavit. Menter alleges, however, that prior to the commencement of these cases, it advised both Debtors and SSC of the potential dual representation, and all parties consented.

On January 27, 1995, Menter filed a copy of the Hubbard Affidavit which has been accepted by the UST as well as the Debtors in lieu of an evidentiary hearing.[4] A summary of the Hubbard Affidavit indicates that Menter presently is handling thirteen files for Agway, the same number of files for Telmark, and twelve files for SSC. Over the period 1992 through 1994, Menter's

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[2] See Supplement to Affirmation of Proposed Attorneys For Debtor, sworn to by Kevin M. Newman, Esq., an officer of Menter, on December 14, 1994, filed on December 15, 1994, in each case.

[3] Menter admits to representing Agway at the time Eagle Rock filed. However, Menter contends that Agway was a distinct entity from Rome Agway co-op and DeRuyter Agway, who were listed as creditors of Eagle Rock.

[4] The Court is also in receipt of a letter, dated 1/25/95, from Stephen A. Donato, Esq., attorney for Agway, indicating that he does not seek an evidentiary hearing on the Final Applications.

representation of these creditors accounted for less than one percent of Menter's annual income.

Menter has not acted as general counsel to any of the three creditors, but has appeared on behalf of each of them in bankruptcy court proceedings. Menter's representation of Agway and SSC dates back to 1975, while it first represented Telmark in 1974.

During the pendency of the Eagle Rock case, Menter did negotiate, on that Debtor's behalf, with Agway through its separate counsel regarding a request that a lien be given to secure the cost of feed. Menter also negotiated with Telmark regarding Eagle Rock's assumption of a truck lease. Menter did not provide any advice to either Eagle Rock or Bargabos regarding SSC during the pendency of their cases. Finally, Menter asserts, upon information and belief that none of its present attorneys own or ever owned any interest in any of the three creditors. (See Hubbard Affidavit, ¶6).

Prior to December 14, 1994, Menter had not disclosed its representation of Agway, Telmark or SSC to the Court, creditors or the UST. Menter's disclosure closely followed the Court's December 12, 1994 receipt of a letter from W.M. Bargabos, inter alia, requesting an adjournment of an evidentiary hearing on a motion filed by Security National Partners, a secured creditor of both Debtors, to vacate the stay imposed pursuant to Code §362(a), so that Debtors could obtain new counsel.

ARGUMENTS

The UST relies on Code §§327(a) and 328(c) in initially seeking denial of the fees sought by Menter in its Final Applications as well as disgorgement of all of the fees previously approved by the Court and paid over to Menter.[5]

The UST asserts that Menter failed to meet the disinterestedness test articulated in Code §327(a), since it represented two of Eagle Rock's creditors and one of Bargabos' creditors pre-petition and during the time period that it was representing both Debtors in their respective Chapter 11 cases. As a result, argues the UST, Menter represented interests that were adverse to both Debtors' estates and pursuant to Code 328(c) the Court should deny all compensation and reimbursement of expenses.

Additionally, the UST cites Menter's failure to initially disclose its dual representation of both Debtors and creditors as preventing the Court from meeting its obligation that it insure compliance with Code §327(a).

Finally, the UST argues that the applicable law mandates both fee denial and disgorgement where a potential conflict of interest remains undisclosed, even though the potential conflict never ripens into an actual conflict of interest, in order to

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[5] In an Amended Objection filed by the UST in both cases on January 26, 1995, it withdrew its request for disgorgement of any fees, but renewed its objection to approval of the Final Applications.

In the Bargabos case, Menter has previously been awarded total fees and disbursements in the sum of $25,647.60, while in the Eagle Rock case, Menter's previous award of fees and disbursements totalled $55,593.38.

protect the integrity of the bankruptcy process.

W.M. Bargabos, while reiterating much of what the UST asserts, cites to specific incidents which he contends are examples of an actual conflict of interest on Menter's part. W.M. Bargabos argues that Menter's alleged failure to pursue actions against Key Bank and its counsel, Hiscock & Barclay, Esqs., as well as it's alleged refusal to seek post-petition financing for Eagle Rock, all arise out of Menter's actual conflict of interest. Finally, W.M. Bargabos alleges that a member of Menter was providing confidential information to a milk co-operative that directly competes with a milk co-operative he helped form.

Menter disputes the factual allegations that Telmark was a creditor of the Debtors at the time the Chapter 11 cases were filed. In addition, Menter contends that at the time of filing the Chapter 11 cases, Agway, another client, was not a creditor of either Debtor. Rather, the actual creditors were two independent Agway co-operatives which may have subsequently merged with Menter's client.

Menter asserts that at no time did it ever represent Telmark or Agway in any matter relating to the Chapter 11 case of Eagle Rock, except that it does acknowledge that it represented the Debtor in connection with the assumption of an equipment lease originally executed between Telmark and a third party. Likewise, Menter asserts that it did not represent SSC with regard to either Debtor and that Menter obtained the consent of both Debtors, as well as SSC, to file the Chapter 11 cases.

Menter disputes W.M. Bargabos' assertions that it failed

to adequately represent the Debtors' interests, contending that Bargabos has engaged in "sheer speculation." Menter asserts that its failure to disclose its representation of Telmark, Agway and SSC was due to inadvertence, and while the potential for a conflict of interest may have existed, no actual conflict of interest occurred and no damage was done to the Debtors' estates.

DISCUSSION

The contested matter sub judice raises several issues that a bankruptcy court must consider in passing upon the fee applications of professionals. The issues are at the very heart of the integrity of the bankruptcy system and its ultimate goal of maximizing a distribution to creditors.

The first issue, as articulated by the UST, concerns the duty of full disclosure and to what extent a professional who seeks appointment, pursuant to Code §327(a) and Federal Rule of Bankruptcy Procedure ("Fed.R.Bankr.P.") 2014, must comply with that duty. The second issue that must be addressed is whether sanctions are mandated in the event that the professional fails to make full disclosure and what sanctions are appropriate. Finally, if full disclosure would have suggested the potential for a conflict of interest, should the professional be barred from continued representation thereafter.

The UST ably argues that if the Court concludes that Menter, in fact, violated its duty of full disclosure at the time the cases were filed, disgorgement and/or denial of all fees is one

of the appropriate sanctions. It relies principally on the rationale of the First Circuit Court of Appeals in Rome v. Braunstein, 19 F.3d, 54 (1st Cir. 1994); In re EWC, Inc., 138 B.R. 276 (Bankr. W.D.Okla. 1992), and In re Hathaway Ranch Partnership, 116 B.R. 208 (Bankr. C.D.Cal. 1990). Those cases and their progeny analyze the debtor's attorneys dilemma initially from the failure to disclose perspective and then move on to assess the conflict of interest issue which invariably exists in the wake of the failure to disclose.

In the instant matter, Menter argues that at the time it sought appointment in the Eagle Rock case neither Telmark nor Agway were creditors of that Debtor. With regard to Telmark, it asserts that Oxbow Dairies, Inc., the predecessor-in-interest to Eagle Rock, had leased a feed truck from Telmark and the lease was later "assumed" by Eagle Rock post-petition. Menter acknowledges that it did represent Eagle Rock in regard to that assumption post-petition.[6]

Turning to Agway, Menter contends that at the time of the Eagle Rock filing, it admittedly represented Agway Inc., but that its client was a separate and distinct entity from Rome Agway Co-op and DeRuyter Agway who were listed as Eagle Rock's creditors. Menter does concede that at a point post-filing, some Agway co-operatives merged with Agway, but it is uncertain if the two co-operatives referenced in Eagle Rock's petition were among those that merged. Menter also acknowledges that post-filing Eagle Rock

[6] The UST points out that in Eagle Rock's schedules, filed approximately 44 days after the petition was filed, the existence of a leasing agreement between Telmark and the Debtors was noted.

and/or Bargabos may have done business with Agway.

Insofar as SSC is concerned, Menter does not deny its pre-petition representation of that creditor, but does assert that it fully disclosed that representation to Bargabos and obtained both Debtors' consent, as well as that of SSC. Menter opines that it inadvertently failed to disclose that representation.

Based upon the case law cited by the UST, Menter either at the time it sought appointment as Debtors' counsel or at a subsequent point post-petition failed in its duty to disclose timely its representation of these three creditors of the Debtors. As the Bankruptcy Court observed in In re EWC, supra, 138 B.R. at page 280, "Therefore, if a person has at any time during employment by the estate, any **'connections with the debtor, creditors, any other party in interest, their attorneys and accountants, the United States Trustee or any person employed in the office of the United States Trustee',** pursuant to Fed.R.Bankr.Pro. 2014(a) and fails to disclose those 'connections' to the best of his or her knowledge, it is necessary and appropriate that employment of that person must be set aside to carry out the provisions of the Bankruptcy Code."

The issue of disqualification of Menter was rendered moot by virtue of the Court's Order of January 4, 1995, which granted Menter's motion to withdraw. Monetary sanctions, however, remain a viable alternative.

This Court is not of the opinion that the failure to disclose standing alone mandates fee denial and fee disgorgement. This Court believes that non-disclosure brings upon the non-

complying professional a full and complete inquiry by a bankruptcy court aimed at determining why full disclosure was not made and whether or not the professional had a conflict of interest which would have been otherwise obvious had full disclosure been made. This is not to suggest that the Court is minimizing the consequences of non-disclosure within the bankruptcy process; however, it is to suggest that each case of non-disclosure needs to be evaluated on its individual merits.

Most of the case law that is cited by the UST for the proposition that failure to disclose in and of itself is the basis to deny or disgorge fees, actually carries the inquiry a step further by analyzing the existence of an undisclosed potential or actual conflict of interest. It is only where a court in most instances finds an actual conflict of interest that it imposes sanctions. This Court believes that the approach adopted by the Bankruptcy Court in EWC, supra, namely requiring the attorney's withdrawal from the case and requiring that they disgorge their fees, represents the extreme. It is the view of this Court that the better approach is that adopted by Bankruptcy Judge Tina Brozman in In re Leslie Fay Companies, Inc., 175 B.R. 525 (Bankr. S.D.N.Y. 1994). Judge Brozman, while acknowledging that the failure to disclose provides an independent basis to disallow a fee, observes that the Court has very broad discretion as to sanctions. In fact, Judge Brozman reached the conclusion that in spite of the debtor's counsel's failure to disclose its pre-petition representation of the debtor's seventh largest creditor, no actual conflict of interest had existed and she did not sanction

debtor's counsel for that specific non-disclosure. Id. at 536.

As the parties have noted, this Court, in an unpublished decision, In re Hotel Syracuse, Case No. 90-0292, (Bankr. N.D.N.Y. October 7, 1992), concluded that debtor's counsel had engaged in a "very real conflict of interest" in representing the debtor's principal in other matters, a representation that had only been disclosed to the Court in a "vague" and "misleading" fashion. However, the Court in a subsequent decision in the same case issued on August 9, 1993, found that it did not appear that counsel's conduct "was such that it rendered legal services that were at odds with the best interest of the Debtor and its creditors, though those services may have also benefitted [Debtors principal] personally."

In the case sub judice, the allegations of non-disclosure and conflict of interest appear to be significantly more serious than those presented in the Hotel Syracuse case. Here Menter made no disclosure, vague or otherwise, and represented creditors of the Debtors with whom they negotiated on the Debtors' behalf in the context of the Chapter 11 cases. Menter negotiated a truck lease assumption with Telmark, as well as negotiating post-petition feed payments to Agway, all on behalf of Eagle Rock. Unlike the factual scenario presented to this Court in the Hotel Syracuse case, the Debtors here complain that Menter violated the attorney client privilege, failed to take action against a secured creditor and its attorneys, failed to pursue post-petition financing, as well as the lease of additional livestock, and they have documented communications with Telmark and Agway during the course of the

Chapter 11 cases. Menter, of course, has refuted these allegations asserting, somewhat disingenuously, that insofar as it is being criticized for actions it did not undertake on Debtors' behalf, the current Final Applications are for services actually rendered.

While this Court can appreciate the dilemma that may face a firm specializing in the handling of Chapter 11 cases from the perspective that it may also represent creditors of prospective Chapter 11 clients, that does not justify non-disclosure of potential conflicts which ripen into actual conflicts to the extent that debtors themselves seek to discharge counsel.

Menter's explanation is that in spite of its failure to disclose and in spite of the fact that an actual conflict existed, it should not be sanctioned because its failure to disclose was inadvertent and its dual representation of Debtors and three of their creditors resulted in no perceptible harm.

Menter points to this Court's fee denial in its decision in In re Ocha, 74 B.R. 191 (Bankr. N.D.N.Y. 1987), and our reliance on the Second Circuit's holding Iannotti v. Manufacturers Hanover Trust Co. Matter of New York, New Haven and Hartford R.R.), 567 F.2d 166 (2d Cir. 1977), to support the premise that fee denial and/or disgorgement are appropriate only where an actual conflict of interest exists and the conflict has a detrimental effect on the quality of the attorney's representation of the debtor. Menter concludes that neither factual scenario exists here.

This Court must conclude that based solely on the record before it, which is plagued with unsubstantiated allegations and

innuendos, disgorgement of fees already approved is not warranted, a conclusion apparently concurred in by the UST (See Footnote #5). Conversely, the Court is of the opinion that the Final Application presented to the Court should not be considered or approved for payment at this juncture. The Final Application in the Eagle Rock case covers the period August 17, 1994 through December 27, 1994, while the similar Application in the Bargabos case covers the period July 12, 1993 through December 27, 1994. As indicated, neither Application is Menter's first. It has previously been authorized payment of total fees and disbursements of $81,240.98 in these cases.

The Court is cognizant of ongoing litigation in two contested matters which may very well determine the success or failure of the Debtors' proposed reorganizations.[7] It is not clear to the Court at this juncture whether Menter's alleged action or inaction, allegedly motivated by its conflicting interests, will detrimentally impact on Debtors' ability to reorganize. It is apparent, however, that Menter's withdrawal from these cases on January 3, 1995, albeit at the urging of the Debtors, will burden these estates with additional administrative expense.[8] This expense will flow directly from the appointment of substitute counsel and that counsel's efforts in getting "up to speed", on

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[7] The Court is presently conducting an evidentiary hearing on Debtors' motion to borrow $400,000, pursuant to Code §364(c) in order to purchase additional cows as well as a motion filed by Security National Partners to modify the automatic stay pursuant to Code §362(d)(2).

[8] On January 3, 1995, the firm of Shaw, Licitra, Parente, Esernio & Schwartz, P.C. was substituted as counsel for both Debtors.

relatively short notice in Chapter 11 cases that have been pending more than two years. Until the fee applications of substitute counsel are filed, the Court cannot determine what portion, if any, should be assessed directly against Menter. Additionally, payment of an administrative expense approximating $23,400 at this juncture may well impact adversely on Debtors' prospect for a successful reorganization of both Debtors. The Court is aware that there has been no significant substantive objection to the content of either Final Application, other than that filed by the UST on December 9, 1994.

Based upon the foregoing, the Court will withhold approval of the Final Applications in their entirety pending either a final confirmation hearing on any plan or plans of reorganization or liquidation proposed by the Debtors or the date of a hearing on any application to convert or dismiss Debtors' Chapter 11 cases.

IT IS SO ORDERED.

Dated at Utica, New York
this day of

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STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge