

1 UNITED STATES BANKRUPTCY COURT
2 EASTERN DISTRICT OF CALIFORNIA
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4 In re:) Case No. 05-22777-D-7
5) Docket Control No. GJH-1
6 MELANIE HUGHES,)
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Debtor.

8 MEMORANDUM DECISION

9 I. INTRODUCTION

10 Under 11 U.S.C. section 327(a) and (c), chapter 7 trustee
11 John Roberts (the "Trustee") seeks to employ Hughes & Pritchard,
12 LLP ("HP"), as his special counsel, for the purpose of
13 prosecuting a fraudulent transfer action filed in the Sacramento
14 County Superior Court (the "Fraudulent Transfer Action") against
15 the above-captioned debtor, Melanie Hughes (the "Debtor"), and
16 Mark Hughes and/or the Hughes Law Group. In his Application of
17 Chapter 7 Trustee to Employ Counsel, filed July 26, 2005 (the
18 "Application"), the Trustee seeks to employ HP as his counsel in
19 regard to at least three matters: prosecution of a legal
20 malpractice claim of the Debtor; in regard to objections to
21 claim; and in regard to the Fraudulent Transfer Action.

22 The United States Trustee ("UST") opposes the Application.
23 Oral argument was presented on September 6, 2005, and in an
24 Interim Order entered on September 7, 2005, the court denied the
25 Trustee's request to employ HP in regard to the legal malpractice
26 claim and objections to claim, based on findings of an actual
27 conflict pertaining to the proposed representation. At the
28 court's request, the Trustee and the UST filed post-hearing

1 briefs in regard to HP's proposed employment as special counsel
2 for the Fraudulent Transfer Action.

3 For the reasons set forth below, the court will deny the
4 Application in its entirety.

5 II. DISCUSSION

6 The record in this case shows that the Debtor is married to
7 Mark Hughes and was married to Mr. Hughes as of the filing of the
8 her chapter 7 petition. As noted above, Mark Hughes and/or the
9 Hughes Law Group are named as defendants in the Fraudulent
10 Transfer Action.

11 The record in this case also shows that HP has represented
12 Clayco C. Arnold, an individual, and Clayco C. Arnold, a
13 Professional Law Corporation (collectively, "Arnold"), in
14 connection with efforts to collect judgments against the Debtor,
15 and in regard to the Debtor's earlier bankruptcy case, a Chapter
16 13 proceeding in this court which was dismissed on a motion
17 prosecuted by HP on Arnold's behalf. HP currently represents
18 Arnold in regard to the Debtor's chapter 7 bankruptcy case, and
19 in regard to the pending Fraudulent Transfer Action. HP is also
20 Arnold's counsel of record in connection with an adversary
21 proceeding in this court, Arnold v. Hughes, Adv. Pro. No. 05-
22 02225 (the "Discharge Action"). In the Discharge Action, Arnold
23 seeks the denial of the Debtor's discharge in the pending chapter
24 7 case, pursuant to 11 U.S.C. section 727, and/or a
25 determination that the debt owed to Arnold is not dischargeable,
26 pursuant to 11 U.S.C. section 523(a).

27 The court notes that in the Complaint that initiated the
28 Discharge Action, Arnold alleges that the Debtor and Mark Hughes

1 carried out an arrangement under which the Debtor's "assets and
2 earnings" were "artificially shifted" to Mark Hughes, so as to
3 defraud Arnold in his efforts to collect his judgments against
4 the Debtor. The UST argues that the Fraudulent Transfer Action
5 therefore involves operative facts that are central to the
6 Discharge Action against the Debtor and her husband.

7 The Trustee acknowledges that with specific exceptions, HP
8 can be employed under 11 U.S.C. section 327(a), only if it does
9 not "hold or represent an interest adverse to the estate" and is
10 disinterested. Section 327(c) provides that in this chapter 7
11 case, an attorney is not disqualified from employment solely
12 because of the attorney's representation of a creditor, unless
13 there is an objection by another creditor or the UST, "in which
14 case the court shall disapprove such employment if there is an
15 actual conflict of interest." Based on the assertion that actual
16 conflicts of interest exist, the UST has opposed the Application.

17 In response, the Trustee asks the court, in reading
18 subsections 327(a) and (c), to analogize to subsection 327(e),
19 and to permit the employment of HP as special counsel because HP
20 does not hold or represent an interest adverse to the estate
21 specifically as to the Fraudulent Transfer Action. See Stoumbos
22 v. Kilimnik, 988 F.2d 949, 964 (9th Cir. 1993).

23 The court, however, finds that HP represents an interest
24 adverse to the estate in regard to the Fraudulent Transfer
25 Action, which is the specific matter for which HP is proposed
26 counsel. Although the facts that pertain to the Discharge Action
27 and to the Fraudulent Transfer Action are not identical, there is
28 a disqualifying relationship and overlap. Perhaps more critical,

1 however, is the very real conflict that arises in the context of
2 settlement of the two actions. In circumstances like those of
3 this case, it is common for a debtor to seek to settle a section
4 523 dischargeability action, in consideration of a cash payment
5 and dismissal of the section 727 action and/or any fraudulent
6 conveyance that might support the 727 action. Here, HP would be
7 put into the precarious position of advising Arnold regarding
8 such a proposed settlement in the Discharge Action, and at the
9 same time advising the Trustee in regard to the merits and
10 prosecution of the Fraudulent Transfer Action. It is realistic
11 to imagine the Debtor agreeing to nondischargeability of the
12 Arnold debt under section 523, in exchange for a dismissal of the
13 section 727 action and the Fraudulent Transfer Action. In such a
14 case, Arnold would benefit at the expense of the estate and HP
15 would be put in the untenable position of advising both Arnold
16 and the Trustee.

17 In reviewing applications for the estate's employment of
18 professionals, the court is ultimately to consider "the
19 protection of the interest of the bankruptcy estate and its
20 creditors" as well as the resolution of the bankruptcy case. In
21 re Harold & Wms. Dev. Co., 977 F.2d 906, 910 (4th Cir. 1992),
22 quoted in In re Arochem Corp., 176 F.3d 610, 621 (2d Cir. 1999).
23 As such, the court is sensitive to the concern raised by the UST,
24 that whether or not HP is determined to represent an interest
25 adverse to the estate in this case, the concurrent representation
26 of the Trustee and Arnold, a major creditor in the case, creates
27 an impermissible appearance of impropriety, in that Arnold could
28 be perceived as holding an undue influence over decisions in

1 proceedings that are critical in the overall administration of
2 the Debtor's case.

3 The UST points out that there are alternative arrangements
4 for HP's employment in connection with the Fraudulent Transfer
5 Action, such as continued prosecution by Arnold, but for the
6 benefit of the estate, with litigation expenses subject to
7 reimbursement under 11 U.S.C. section 503(b)(3)(B) and (4). In
8 denying the Application, the court is not making any
9 determination in regard to such an alternative arrangement.

10 The court will issue an order consistent with this
11 memorandum.

12 Dated: September 12, 2005

13 /s/
14 ROBERT S. BARDWIL
15 United States Bankruptcy Judge
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