Bankr. R. 9011

Toth-Fejel v. Kramer & Toth-Fejel Dist. Ct. NO. 99-343-JO
In re Des Chuttes Investments, Inc.
Bankr. Case NO. 398-31863-psh11

11/3/99 Dist. Aff'd. PSH 1999 WL 1012870

Appellant Toth-Fejel filed a Chapter 11 petition on behalf of Des Chuttes Investments, Inc. and thereafter filed a Motion for Approval of a Settlement Agreement. Cupertino National Bank filed a motion for sanctions against Des Chuttes, Toth-Fejel and his law firm, Kramer and Toth-Fejel for both filings, under Federal Rule of Bankruptcy Procedure 9011.

The bankruptcy court, in an unpublished opinion, dismissed the Chapter 11 petition and granted Cupertino's motion for sanctions as to Mr. Toth-Fejel for failing to make proper inquiry before filing either the petition or the Motion. As a penalty the court assessed all of Cupertino's reasonable legal fees and expenses, totaling $105,424.29, jointly and severally against Des Chuttes, Fayez Kahn, its principal, and Toth-Fejel. Cupertino thereafter filed a motion for reconsideration asking the court to extend the sanctions against Toth-Fejel to his law firm, Kramer and Toth-Fejel.

The bankruptcy court, in a revised letter opinion, affirmed the original sanctions imposed against Toth-Fejel and Des Chuttes but based those sanctions only on the filings of the petition. The court declined to extend the sanctions to Kramer and Toth-Fejel, and withdrew the sanctions against Fayez Kahn. Both Cupertino and Toth-Fejel appealed.

On appeal Toth-Fejel argued that the bankruptcy court should not have included as sanctions for filing a frivolous petition the fees and expenses incurred by Cupertino in responding the

Motion to Approve Settlement Agreement. The District Court disagreed. It noted that the bankruptcy court recognized that it could not impose sanctions for the filing the Motion for Approval of Settlement agreement but nonetheless found that all of the costs imposed as sanctions were "directly and unavoidably" caused by the filing of the petition. The district court found that the bankruptcy court's "allocation of attorney fees and costs appear to be entirely reasonable for the filing of this petition, which [the bankruptcy judge] found to be the most egregious violation she had incurred in her judicial career."

The District court also affirmed the bankruptcy court's decision not to extend the sanctions to Mr. Toth-Fejel's law firm, Kramer & Toth-Fejel. It doing so it relied upon the bankruptcy court's finding that the two partners in the firm practiced independently and in different areas of law without reviewing each others work. The District Court agreed with the bankruptcy court that, under the circumstances, the premises upon which the rule allowing extension of sanctions to a law firm was based, that it would encourage self policing, was not present and therefore extension of the sanctions to Mr. Toth-Fejel's firm was not warranted.

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF OREGON

ANDREW TOTH-FEJEL, Appellant, v. KRAMER & TOTH-FEJEL LAW FIRM; ET AL., Appellees.	Civil No. 99-343-JO OPINION AND ORDER

Christine Y. Coers-Mitchell
McEWEN GISVOLD RANKIN CARTER & STREINZ
1100 S.W. Sixth Avenue, Suite 1600
Portland, OR 97204

Attorney for Appellant

Daniel F. Vidas
DUNN CARNEY ALLEN HIGGINS & TONGUE
851 S.W. Sixth Avenue, Suite 1500
Portland, OR 97204-1357

Dennis P. Rawlinson
MILLER NASH WIENER HAGER & CARLSEN
111 S.W. Fifth Avenue, Suite 3500
Portland, OR 97204

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Nels R. Nelsen
GRAY CARY WARE & FREIDENRICH
400 Hamilton Avenue
Palo Alto, CA 94301-1825

Attorneys for Appellees

JONES, Judge:

Attorney Andrew Toth-Fejel appeals a final decision by the bankruptcy court granting Cupertino National Bank's ("Cupertino") motion for sanctions (payable to Cupertino) of $105,424.29, jointly and severally, against Toth-Fejel and his client, Des Chuttes Investments, Inc ("Des Chuttes").[1] Cupertino also appeals that order, arguing that Toth-Fejel's firm, Kramer & Toth-Fejel, should be jointly liable for sanctions imposed upon Toth-Fejel.

Pursuant to 28 U.S.C. § 158(c)(1) and Federal Rules of Bankruptcy Procedure 8001(e), Toth-Fejel and Cupertino elected to have the appeal heard by this court instead of the bankruptcy appellate panel; consequently, this court has jurisdiction over the appeal pursuant to 28 U.S.C. § 158(a)(1).[2]

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[1] The sanctioned conduct at issue in this appeal arose in In Re Des Chuttes Investments, Inc., Bankr. Ct. Case No. 398-31863-psh11.

[2] Note: This is an "appellate" review of a final decision of the bankruptcy court, not a review of findings and recommendations in non-core proceedings under 28 U.S.C. § 157(c)(1) and Bankr. R. Civ. Pro. 9033.

NATURE OF THE ACTION AND PROCEEDINGS BELOW

The sanctions at issue arose out of Toth-Fejel's representation of Des Chuttes in a frivolous Chapter 11 bankruptcy proceeding. Cupertino's interests were adversely affected by that proceeding.

Des Chuttes filed a Chapter 11 petition, and a related Motion for Approval of Settlement Agreement ("Motion"), on March 17, and April 9, 1998, respectively. Cupertino moved the court, on April 14, 1998, to sanction Des Chuttes, Toth-Fejel, and his firm, Kramer & Toth-Fejel, for both filings, under Federal Rule of Bankruptcy Procedure 9011.[3]

On June 11, 1998, the bankruptcy court dismissed the Chapter 11 petition and granted Cupertino's motion for sanctions. The court awarded sanctions against Des Chuttes for filing a bankruptcy petition in bad faith, and against Toth-Fejel for failing to make a proper inquiry before filing either the petition or the Motion. As a penalty, the court assessed all of Cupertino's reasonable legal fees and expenses, totalling $105,424.29, jointly and severally, against Des Chuttes, Fayez Kahn,[4] and Toth-Fejel. That court ordered that payment be made to Cupertino.

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[3] Rule 9011, as amended on December 1, 1997, mirrors Fed. R. Civ. Pro. 11, except for the differences discussed later in the opinion.

[4] Kahn was president of Des Chuttes when the sanctioned conduct occurred.

On June 22, 1998, Cupertino filed a motion for reconsideration, asking the court to extend the sanctions to Kramer & Toth-Fejel. CR 114. After a hearing on July 22, 1998, the court issued a revised opinion. That revised opinion, entered on October 6, 1998, affirmed the original imposition of sanctions against Toth-Fejel and Des Chuttes, but based those sanctions only on the filing of the petition[5], declined to extend sanctions to Kramer & Toth-Fejel, and withdrew sanctions against Fayez Kahn. The court entered final judgment on November 17, 1998; Toth-Fejel and Cupertino timely appealed.

STATEMENT OF FACTS

The events leading to the present action began in 1997, with the dishonest business dealings of California businessman Zulfigar Eqbal.[6] Eqbal owned land and a house in Fremont, California, which he financed with a construction loan from Cupertino.

Cupertino learned that Eqbal had made material misrepresentations in his loan application. Among other things, Eqbal lied about his income and employment, and concealed that he previously had filed for bankruptcy, had changed his legal name,

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[5] The court recognized the "safe harbor" provision prohibited sanctions for the Motion for Approval of Settlement Agreement.

[6] Eqbal is not a party to the present action.

and was liable for an outstanding judgment. On November 13, 1997, Cupertino declared his loan in default.

At the time of the default, at least three other creditors held liens against Eqbal's Fremont property. Lithographix, Inc., held a judgment lien junior to Cupertino's. Allied Services, Inc., and Juan V. Tinoco Concrete filed construction liens of $131,548 and $45,064.75, respectively, sometime after Lithographix filed its lien.

Eqbal aspired to use two family controlled corporations[7] and the federal bankruptcy court to shield his Fremont home from foreclosure by Cupertino and to escape liability for some or all of his remaining debt. First, he had Si-Va Tech, posing as a disinterested third party, attempt to purchase his defaulted Cupertino debt at a discount. When that failed, he then orchestrated the Des Chuttes Chapter 11 bankruptcy filing to invoke the automatic stay provision, which prevented Cupertino from conducting its planned foreclosure sale.[8]

Si-Va Tech made three unsolicited offers, in November, 1997, to purchase the Eqbal note and deed of trust from Cupertino

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[7] Those corporations are Des Chuttes and Si-Va Tech, Inc. Des Chuttes is owned by Muneer Begum, Eqbal's mother. Si-Va Tech is a wholly owned subsidiary of Sameena, Inc., which is owned by Eqbal's wife, Sameena Ikbal. Des Chuttes' president at the time of sanctions, Fayez Kahn, is a cousin of Eqbal's wife.

[8] Section 362 of Chapter 11 automatically imposes a stay on all proceedings against the debtor while the bankruptcy case is resolved. 11 U.S.C. § 362.

at a discount. Cupertino rejected those offers, suspecting that Eqbal was attempting to obtain an assignment of Cupertino's interest to a friendly entity which would then conduct a foreclosure sale that would eliminate Lithographix' judgment lien and allow Eqbal to keep the Fremont property.

In February or early March, 1998, Toth-Fejel agreed to represent Des Chuttes in Chapter 11 proceedings in Oregon. Des Chuttes, which was incorporated in October, 1997, recently had purchased the construction liens on Eqbal's Fremont property.

On March 5, 1998, Cupertino recorded a Notice of Trustee's Sale for Eqbal's Fremont property, setting a sale date of April 2, 1998. On March 18, 1998, however, Toth-Fejel notified Cupertino that Des Chuttes had acquired the construction liens on the Fremont property and filed for Chapter 11 bankruptcy. Toth-Fejel asserted that the Chapter 11 automatic stay barred Cupertino's foreclosure sale, because the sale would terminate Des Chuttes' construction liens, which were assets of the bankruptcy estate.

Cupertino responded to Toth-Fejel by informing him of the pre-petition history between Eqbal and the bank and stating its belief that the bankruptcy filing was in bad faith. In spite of Cupertino's warning, Toth-Fejel and Des Chuttes proceeded aggressively.

On March 23, 1998, Des Chuttes sought and obtained an order enforcing the automatic stay with respect to Cupertino's pending

foreclosure sale. On April 9, 1998, Des Chuttes filed the Motion for Approval of Settlement Agreement. That "settlement agreement", which Eqbal wrote, invoked the court's power to force Cupertino to sell the Eqbal note and deed to Si-Va Tech.

On April 14, Cupertino filed motions for relief from the stay, to dismiss the Chapter 11 proceeding, and for sanctions. Toth-Fejel received a copy of those motions on April 17, 1998. Des Chuttes, Toth-Fejel, and his firm, Kramer & Toth-Fejel, failed to file a response to the motion for sanctions. Toth-Fejel appeared at the hearing, representing himself, debtor and his law firm. The Bankruptcy Court dismissed Des Chuttes' petition and awarded sanctions on June 11, 1998.

BANKRUPTCY COURT FINDINGS

In its June 11, 1998, opinion, the bankruptcy court found that Des Chuttes was a sham corporation, formed at the time Eqbal was facing probable foreclosure on the Fremont property, and that its only assets were two construction liens against the Fremont property. The court also found Des Chuttes' alleged debt to be highly suspect: Of the eleven creditors listed in the Chapter 11 petition, only two were real. One of the two real creditors was Sameena, Inc., which loaned Des Chuttes $7,500 to pay Toth-Fejel's retainer. The court further found that Des Chuttes "had no other business activities, no employees and no income, no debt other than that necessarily acquired in its scheme, and no expectation whatsoever of reorganization." In re Des Chuttes

Investments, Inc., Bankr. Case No. 398-31863-psh11 (Letter Opinion, June 11, 1998) (CR 108), p. 14. The court concluded:

> the evidence overwhelmingly shows that [Des Chuttes] is Eqbal's creature and that the sole purpose of its bankruptcy formation and filing was, first to halt the foreclosure on his property and, second, to force Cupertino to sell its interest in the Eqbal note and deed of trust, hopefully at a discount, to his other creature, Si-Va Tech.

Id.

Although the fraud did not originate with Toth-Fejel, his unprofessional legal representation of Des Chuttes and Eqbal was essential to that fraud. The court found that Toth-Fejel wilfully breached his duty to investigate both the legitimacy of Des Chuttes' bankruptcy petition, which was clearly filed in bad faith, and the Motion for Approval of Settlement Agreement, which was neither warranted by existing law nor premised on a good faith basis for modification of existing law. Id. at 11.

After a motion for reconsideration was filed, the court issued a revised opinion on October 2, 1998. In that opinion, the court concluded that the portion of Cupertino's motion for sanctions that was based on Toth-Fejel's filing of the Motion for Approval of Settlement Agreement violated the safe harbor clause of Rule 9011 (c)(1)(A), which requires notice to the offending party 21 days before filing a motion for sanctions with the court.[9] The court, however, found that $105,424.29 was an

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[9] The safe harbor provision of Bankruptcy Rule 9011 (c)(1)(A) provides:

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"appropriate" sanction for filing the bankruptcy petition, which has no safe harbor protection, stating:

> I conclude that I cannot award sanctions against any of these entities based solely[10] on the debtor's filing of the Motion for Approval of Settlement Agreement. I may, however, given the exception to this preservice requirement which appears in Bankruptcy Rule 9011 for the filing of petitions, award appropriate sanctions if I find that a petition has been filed in violation of subsection (b).

In re Des Chuttes Investments, Inc., Bankr. Case No. 398-31863-psh11 (revised Letter Opinion, October 2, 1998) (CR 163), p. 13.

The court found Des Chuttes and Toth-Fejel, jointly and severally, liable for the sanctions. The court did not, however, extend liability to Kramer & Toth-Fejel, citing exceptional circumstances. Id. at 20.

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[9](...continued)
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).

[10] There is no record that the court awarded any sanctions for violations protected by the "safe harbor" provision of Rule 9011(c)(1)(A). I treat her use of the term "solely" as surplusage, as she clearly found she had no authority to award any other sanctions.

ISSUES ON APPEAL

Both Toth-Fejel and Cupertino appeal the bankruptcy court's October 6, 1998, order. Toth-Fejel argues that the court erred in three ways. First, because Cupertino served the motion for sanctions on Toth-Fejel without a summons, the court should not have allowed any sanction. Second, because Rule 9011(c)(1)(A) requires notice 21 days before filing a motion for sanctions based on any filing other than filing the petition, the court erred in awarding Cupertino's reasonable fees and expenses incurred during the entire bankruptcy proceeding. Third, Toth-Fejel argues that the court abused its discretion by imposing sanctions beyond what is required for deterrence.

Cupertino argues only that the court erred in not extending liability for the sanctions to the law firm of Kramer & Toth-Fejel.

STANDARDS OF REVIEW

A bankruptcy court's conclusions of law are reviewed *de novo*. Grey v. Federated Group, Inc. (In re Federated Group, Inc.), 107 F.3d 730, 732 (9th Cir. 1997). The bankruptcy court's findings of fact cannot be set aside unless "clearly erroneous." Fed. R. Bankr. Pro. 8013. Mixed questions of law and fact are reviewed *de novo*. In re Amy Chang, 163 F.3d 1138, 1140 (9th Cir. 1998). The bankruptcy court's evidentiary rulings are reviewed for abuse of discretion. In re Gergely, 110 F.3d 1448, 1452 (9th Cir. 1997).

DISCUSSION

1. Cupertino's Failure to Serve a Summons with the Motion for Sanctions

Toth-Fejel asserts that Bankruptcy Rules 9011 and 7004 require that a motion for sanctions be served with a summons.[11] He argues that because he was not served a summons along with Cupertino's motion for sanctions, the court cannot impose sanctions.

A. Toth-Fejel Did Not Preserve The Issue for Review

Toth-Fejel did not challenge the form of notice in bankruptcy court and raises the issue for the first time on appeal. He urges this court to consider his argument nevertheless, an invitation this court declines to accept.

Although this court may elect to decide an issue in a bankruptcy case raised for the first time on appeal, it is not required to do so. Matter of Pizza of Hawaii, Inc., 761 F.2d 1374, 1379 (9th Cir. 1985). I have considered Toth-Fejel's argument, that interpretation of the service provision of Rule 9011, which was recently amended, would help resolve confusion about the service requirements for a motion for sanctions in bankruptcy court. Unfortunately, even if I were inclined to reach the merits of this interesting issue, I could

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[11] Rule 9011(c)(1)(A) provides that a motion for sanctions shall "be served as provided in Rule 7004." Rule 7004 provides that service on an individual be made "by mailing a copy of the *summons and complaint* to the person upon whom process is prescribed." (Emphasis added.)

not because Toth-Fejel waived his right to object to the form of service by failing to do so in a timely manner.[12]

The court also notes that even if Toth-Fejel had preserved this argument, he would have lost on the merits. The question of whether Rule 9011 requires service of a summons with a motion for sanctions was raised in bankruptcy court by counsel for Kramer &

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[12] Under the Federal Rules of Civil Procedure, the appropriate time to challenge a notice defect is in the noticed party's first response to a complaint. Fed.R.Civ.P. 12(h)(1). The penalty for failing to raise the defense at the appropriate time is waiver. See Empire Kosher Poultry, Inc. v. Hallowell, 816 F.2d 907, 912 (3rd Cir. 1987). Rule 1011 incorporates Fed. R. Civ. P. 12 into the Bankruptcy Rules. Fed. R. Bankr. P. 1011(b).

Although Toth-Fejel now argues his notice was defective, he concedes that he received a copy of the Motion for Sanctions, which he responded to, albeit unsuccessfully, at the hearing held May 28-29, 1998.

Toth-Fejel. The bankruptcy court ruled that it does not, and I agree with that court's conclusion.[13, 14]

2. The Bankruptcy Court's Award of Sanctions Based Upon Des Chuttes' Motion for Approval of Settlement Agreement

Toth-Fejel next asserts that, even if the bankruptcy court correctly sanctioned him for filing the petition, it erred to the extent it awarded any of Cupertino's attorney fees and expenses that Cupertino incurred opposing the Motion for Approval of Settlement Agreement. He cites the "safe harbor" language of Rule 9011(c)(1)(A), which applies to all filings with the bankruptcy court except petitions.[15]

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[13] As the bankruptcy court pointed out, Toth-Fejel's reading of rules 9011 and 7004 would be quite problematic. If, as he argues, the requirement, in Rule 9011(c)(1)(A), that service be made "as provided in Rule 7004" means that a summons is required, then, under the same principle of construction, a complaint must also be necessary, since the rule requires "mailing of a summons *and* complaint." (Emphasis added). However, that interpretation makes no sense, because Rule 9011(c)(1)(A) requires that a request for sanctions be commenced "by motion." In re Des Chuttes Investments, Inc., Bankr. Case No. 398-31863-psh11 (transcript of hearing on Motion to Extend Sanctions to Law Firm of Kramer & Toth-Fejel, held July 22, 1998) (CR 176), p. 11.

The bankruptcy court concluded that the phrase in Rule 9011, requiring service "as provided in Rule 7004", requires that motions for sanctions be served directly to the individual whose conduct is being challenged (as opposed to serving that party's counsel, as provided in Rule 7005). Id.

[14] As a jurisdictional matter, a summons is not required, because the parties to a proceeding and their attorneys are already under the jurisdiction of the bankruptcy court.

[15] It is referred to as the "safe harbor" provision because a party may eliminate the risk of sanctions by withdrawing or correcting the offending motion during the

(continued...)

Cupertino concedes that it did not comply with the safe harbor provision with respect to its motion for sanctions based on Des Chuttes' Motion for Approval of Settlement Agreement.

Following argument, this case involved the simple issue of whether the bankruptcy court may include as sanctions for filing a frivolous bankruptcy petition the legal fees and expenses incurred because of Des Chuttes' frivolous Motion to Approve Settlement Agreement. I find that the Bankruptcy Court judge recognized her error that she could not legally impose any sanctions for the filing of the Motion, yet concluded that the penalty assessed was fully justified without regard to any sanctions for filing the "Motion."

Rule 9011(c)(2) allows the court to assess "some or all of the reasonable attorney's fees and other expenses incurred as a direct result of the violation." (Emphasis added.) In her October 2, 1998, opinion, the Bankruptcy Court judge wrote, "I have not included any fees or costs which Cupertino did not incur for services directly and unavoidably caused by the violation of the rule." Revised Letter Opinion, October 2, 1998, p. 16. Moreover, the defendants never requested an allocation between the petition sanctions and the motion sanctions at the Bankruptcy Court, nor did they preserve Cupertino's itemized expense report

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[15](...continued)
mandatory 21-day waiting period. See Advisory Committee Notes to Rule 11.

in the appellate record. I refuse to review this discretionary call by the trial judge on this appeal. Her allocation of attorney fees and costs appear to be entirely reasonable for the filing of this petition, which she found to be the most egregious violation she had incurred in her judicial career.

3. Bankruptcy Court's Decision Not To Extend Sanctions to Kramer & Toth-Fejel

Cupertino cross appeals, alleging that the bankruptcy court erred by failing to extend the sanction award to the law firm of Kramer & Toth-Fejel. Cupertino asserts that there are no "exceptional circumstances," as required by Rule 9011(c)(1)(A), to justify excusing the law firm from joint liability for Toth-Fejel's sanctions.

The bankruptcy court discussed this issue at length in its revised letter opinion. In the final analysis, the court concluded that exceptional circumstances militated against doing so. The court noted that idea of holding firms jointly liable for their individual attorney's sanctions was premised on the assumption that it would encourage self-policing, thereby deterring sanctionable conduct. The court then noted that this premise was not applicable in this case, because the two partners in Kramer & Toth-Fejel practiced independently, and in different areas of the law. Mr. Kramer asserted, through separate counsel, that he is not competent to review the substantive content of Toth-Fejel's bankruptcy pleadings and, for that reason, does not

review his work. He further testified that he had no actual notice of Cupertino's motion for sanctions against Kramer & Toth-Fejel until after the May 28-29, 1998 hearing, because Toth-Fejel chose not to inform him until then.

Given the bankruptcy court's findings that (1) Toth-Fejel was not an agent for Kramer & Toth-Fejel, at least in the typical sense contemplated by Rule 9011; and (2) that extending sanctions to Kramer & Toth-Fejel would not further Rule 9011's purpose of deterrence, the court's finding of exceptional circumstances was correct. Accordingly, the bankruptcy court did not err in refusing to extend the sanctions to Kramer & Toth-Fejel.

CONCLUSION

The decision of the bankruptcy court is AFFIRMED.

DATED this 2nd day of November, 1999.

ROBERT E. JONES
U.S. District Judge