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BANKRUPTCY LAW

Sanctions in Bankruptcy: A Brief Overview

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In seeking the imposition of sanctions in a bankruptcy case, practitioners invariably invoke Bankruptcy Rule 9011 as the basis for sanctions. In truth, depending on the case, a bankruptcy court can impose sanctions under any of several sources of authority, including not only Rule 9011, but also the court's own inherent power; Section 1927 of Title 28; Bankruptcy Code Section 105(a); and the specific statute or rule applicable to the case before the court. This article briefly summarizes this concept.

Rule 9011

Rule 9011(b) provides in relevant part that an attorney or unrepresented party, by presenting to the court a pleading or other paper, is certifying that to the best of the person's knowledge, information and belief, formed after an inquiry reasonable under the circumstances, that (i) it is not being presented for an improper purpose, such as to harass or to cause unnecessary delay; (2) the legal contentions are warranted by existing law or a nonfrivolous argument for the extension of new law; and (3) the allegations have evidentiary support. Rule 9011(c) provides that violation of Rule 9011(b) can result in sanction upon the offending attorneys, law firms or parties.

The concern of Rule 9011 is not the truth or falsity of the representation in itself, but rather whether the party making the representation reasonably believed it at the time to have evidentiary support. In determining whether a party has violated Rule 9011, the court need not find that the party acted in bad faith. The imposition of Rule 9011 sanctions requires, instead, only a showing of objectively unreasonable conduct.

In *In re Taylor*, for example, the Third Circuit recently held that a bankruptcy court did not abuse its discretion when it imposed sanctions under Rule 9011 against a lender's attorney and the attorney's law firm for making false and misleading statements in a motion. The court held that even assuming that the statements in the lender's motion for relief from automatic stay — that the Chapter 13 debtors had failed to make regular payments on their mortgage — were literally true, they were misleading, because the motion failed to indicate that the debtors had made partial payments and failed to indicate that the debtors' failure to make the remaining payments resulted from a bona fide dispute over the payment amount and not from a simple default.

The court found that the attorney had failed to make a reasonable inquiry before it made such false or misleading statements as to the debtors' alleged failure to make payments, as well as false statements alleging that the debtors lacked equity in their home, on the grounds that the attorney had no direct contact with the lender, the attorney had relied solely on a computer database run by a third-party vendor for information on the loan, such database provided no information as to the debtors' equity and the attorney should have directly contacted the lender for clarification after the debtors had submitted documentation indicating that they had made partial payments. 655 F.3d 274, 283-86 (3d Cir. Aug. 24, 2011).

Also, in *Dahlgren v. Palone (In re Dahlgren)*, a New Jersey district court recently affirmed a bankruptcy court order imposing Rule 9011 sanctions against a Chapter 13 debtor's attorney for twice submitting a patently unconfirmable plan. 2010 WL 5287411 at **4, 8-9 (D.N.J. Dec. 17, 2010).

The imposition of sanctions under Rule 9011 is subject to a number of procedural requirements. First, a "safe harbor" provision in subpart (c) provides that a motion for sanctions must be made separately from other motions and must describe the specific conduct at issue; alternatively, in the absence of a motion,

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the court may enter an order directing the party to show cause why it has not violated Rule 9011. Second, a motion for sanctions can be filed only after the expiration of the safe-harbor period of 21 days following the date of service of the motion. Finally, the "supervisory rule" requires that a motion for sanctions be filed before the entry of a final judgment when the motion arises out of conduct that occurred prior to the final judgment. Courts routinely deny Rule 9011 motions for failure to satisfy any of these requirements.

Court's Inherent Power

A bankruptcy court has inherent power to impose sanctions, monetary or nonmonetary, against a party or an attorney for conduct abusive to the judicial system, i.e., acting in bad faith, vexatiously, wantonly or for oppressive reasons. While Rule 9011 requires only a showing of objectively unreasonable conduct, the invocation of a federal court's inherent power to sanction, in contrast, requires a finding of subjective bad faith. Further, when bad-faith conduct can be adequately sanctioned under Rule 9011, the court ordinarily should rely on Rule 9011 rather than its inherent power. If Rule 9011 is inapplicable, however, the court may safely rely on its inherent power. Whereas the other mechanisms for imposition of sanctions reach only certain individuals or conduct, the inherent power extends to a full range of litigation abuses.

In *In re Brookdale Gardens Ass'n, Inc.*, for example, a New Jersey bankruptcy court invoked its inherent power to impose sanctions in the form of attorney's fees against certain nondebtors for their role in causing a condominium association to file a Chapter 11 case in bad faith and thereby use the bankruptcy case to change the forum for the resolution of a pending state court case. 2010 WL 2015264 at **6-7 (Bankr. D.N.J. May 20, 2010).

Before a court may impose sanctions against a party or attorney under its inherent power, the party or attorney must receive notice of the precise sanctions to be imposed and an opportunity to respond to the charges asserted.

Section 1927

Section 1927 of Title 28 provides that an attorney who unreasonably and vexatiously multiplies the proceedings in any case may be required to satisfy the excess costs, expenses and attorneys' fees reasonably incurred because of such conduct. Examples of actionable conduct include misrepresenting facts, advancing meritless claims, unfairly manipulating the Bankruptcy Code and advancing claims for an improper purpose such as harassment or delay. Mere misunderstanding, bad judgment or well-intentioned zeal do not qualify.

In *In re Schaefer Salt Recovery, Inc.*, for example, a New Jersey bankruptcy court recently awarded attorneys' fees and expenses against the debtor's attorney, under Section 1927, for filing a Chapter 7 petition only 37 days after the dismissal of the debtor's earlier improperly filed Chapter 11 case, and for filing the petition solely to stay a state-court tax foreclosure proceeding. The court denied, however, sanctions for the filing of the earlier Chapter 11 case, fees and costs incurred by the movant in the tax foreclosure proceeding, and fees and costs incurred by the movant in appealing the bankruptcy court's initial denial of his request for fees in the Chapter 7 case. 444 B.R. 286, 295-301 (Bankr. D.N.J. 2011).

Although a motion under Section 1927 is not subject to any safe-harbor provision, the attorney must receive notice of the motion and an opportunity to be heard. Also, although the supervisory rule does not apply to sanctions under Section 1927, the motion should be filed within a reasonable time.

Section 105(a)

Under Section 105(a), a bankruptcy court has broad powers to implement the provisions of Title 11 and to prevent abuse of the bankruptcy process. Although the Third Circuit has not expressly addressed whether Section 105(a) is a codification of a federal court's inherent power to sanction bad-faith conduct, or whether a bankruptcy court may impose sanctions under its inherent power even when Section 105(a) is inapplicable, courts have held that Section 105(a) authorizes a bankruptcy court to sanction attorneys for litigation abuses, including contempt, in order to protect the integrity of the Bankruptcy Code and the judicial process, and in order to enable the court to maintain control of its courtroom and docket. Like Section 1927, Section 105(a) requires a showing of bad faith and vexatious, wanton and oppressive conduct.

Most recently, in *Clemente v. Clemente (In re Clemente)*, a New Jersey district court affirmed a bankruptcy court order denying sanctions under Section 105(a). The District Court noted, however, that the Bankruptcy Court could have found that the defendant, in forcing the plaintiff to incur significant legal fees and in failing to comply with discovery requests, had engaged in sufficiently vexatious or bad-faith conduct to warrant an award of attorney's fees. 2011 WL 2039072 at **3-4 (D.N.J. May 23, 2011).

Applicable Statute or Rule

The specific statute or rule applicable to a matter may provide for the imposition of sanctions. Examples of statutes that authorize sanctions include Bankruptcy Code Sections:

- 303(i), addressing a dismissed involuntary petition;
- 362(k), addressing a violation of the automatic stay; and
- 523(d), addressing a dismissed complaint for nondischargeability of consumer debt.

Federal Rules that authorize sanctions include:

- 16(f), addressing failure to attend a pretrial conference;
- 37, addressing failure to make discovery;
- 45(e), addressing failure to obey a subpoena; and
- 56(h), addressing a summary judgment affidavit submitted in bad faith.

Bankruptcy Rules that authorize sanctions include:

- 2019(e), addressing failure to disclose representation of multiple creditors or equityholders;
- 3001(c)(2), addressing failure to provide certain information in a proof of claim in an individual case; and
- 8020, addressing a frivolous appeal.

Finally, Local Bankruptcy Rule 9019-2(d)(7) authorizes sanctions for failure to attend a mediation conference. ■