(Cite as: 1995 WL 547805 (Bankr.D.Vt.))

In re ST. JOHNSBURY TRUCKING CO., INC., Debtor.

The OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF ST. JOHNSBURY TRUCKING

COMPANY, INC., and St. Johnsbury Trucking Company, Inc., Plaintiffs,

v.

BANKERS TRUST COMPANY, as agent, Defendant.

BANKERS TRUST COMPANY, as agent, Counterclaimant

v.

ST. JOHNSBURY TRUCKING COMPANY, INC., and William M. Clifford, Counterclaim

Defendants

Nos. 93-B-43136 (FGC), 93-1073.

United States Bankruptcy Court, D. Vermont.

Sept. 7, 1995.

C.O'C. Reis of Obuchowski & Reis, Bethel, VT; and, S.L. Chenetz, and R. Levy, Jr. of Marcus Montgomery, Wolfson, P.C., New York City, for Official Committee of Unsecured Creditors (Committee).

H. Berman and M.D. Bloom of Greenberg, Traurig, Hoffman, Rosen & Quentel, New York City, for St. Johnsbury Trucking Co., Inc. (Debtor).

G.J. Vitt, and C. Platto of Brooks, McNally, Whittington, Platto & Vitt, Norwich, Vermont; and R.B. Fiske, Jr. of Davis, Polk & Wardwell, New York City, for Bankers Trust Company (BT) and B.M. Freeman, Esq.

K. McAndrew and S.R. Knapp of Dinse, Erdmann & Clapp, Burlington, VT, for Winthrop,

Stimson, Putnam & Roberts (WSP&R) and L.T. Crowley, Esq.

M.A. Cooper of Sullivan & Cromwell, New York City, and P.F. Langrock of Langrock, Sperry & Wool, Middlebury, VT, for O'Melveny & Myers (O'M&M) and A.C. Harris, Esq.

J. Sigel and S.T. Hoort of Ropes & Gray, Boston, Mass., for William M. Clifford (Sanctions Counsel).

MEMORANDUM OF DECISION IN RESPONSE TO REMAND FROM DISTRICT COURT

FRANCIS G. CONRAD, Bankruptcy Judge.

***1** Chief District Judge J. Garvan Murtha has instructed us to clarify [FN1] on remand our intentions with respect to two orders of this Court directing the Sanctions Parties to turn over allegedly privileged materials in this adversary proceeding. Our preference and intention is that all privileged matters be turned over to Sanctions Counsel forthwith.

The first of the two orders of this Court that are at issue is our October 27, 1994, "Order Commencing Proceedings to Determine Whether Sanctions Should be Imposed" in the instant proceeding. That Order contained a finding that the Sanctions Parties' conduct "constitutes ... a prima facie case of perpetrations of fraud upon this Court...." [FN2] Committee v. Bankers Trust, No. 93-1073, slip op. at 2 (Oct. 27, 1994) (hereinafter "Turnover Order"). Based upon that finding, our Turnover Order terminated all privileges of the Sanctions Parties, including attorney-client and work product privileges. It also ordered them to turn over purportedly privileged documents to Sanctions Counsel. A substantially identical order was also entered in the main case, pending in the Southern District of New York (SDNY), on the same date. In re St. Johnsbury Trucking Co., Inc., No. 93-43136, slip op. (Oct. 27, 1994).

The Sanctions Parties promptly appealed both orders to the District Courts of Vermont and SDNY, and filed motions for writs of mandamus in both venues, asking that we be ordered to vacate our orders terminating the privilege and turning the documents over to Sanctions Counsel. At the urging of the parties, the two District Court judges in Vermont and SDNY agreed that the SDNY matters would proceed first and the Vermont Court would defer action. The SDNY Court granted the Sanctions Parties' motion for writ of mandamus in the main case, In re St. Johnsbury, 176 B.R. 122 (S.D.N.Y. 1994), and Sanctions Counsel appealed. The SDNY sanctions proceeding was eventually settled, and the appeals dismissed.

The Sanctions Parties' appeal and motion for mandamus in connection with the Vermont Turnover Order, however, remained unresolved at the time Sanctions Counsel moved for an order directing the Sanctions Parties to submit the contested documents to this Court for in camera review. We did not attempt at this time to enforce the Turnover Order because the matters before the District Court had not been resolved. Our "Memorandum of Decision

Ordering In Camera Review of Allegedly Privileged Materials," which appears at 184 BR 446, (hereinafter "In Camera Order"), was issued June 28, 1995. The Order granted Sanctions Counsel's motion, and directed that the same documents we had ordered produced to Sanctions Counsel in our Turnover Order be produced for review by Senior Bankruptcy Judge Charles J. Marro. The Sanctions Parties promptly moved in the District Court for leave to appeal the In Camera Order, for a stay, and for a writ of mandamus to vacate it. Judge Murtha denied the relief Sanctions Parties sought in his "Ruling on Emergency Motions for Stay and Emergency Motion for Leave to Appeal," In re St. Johnsbury Trucking Co., Inc., No. 2:94CV322, slip op. (D.Vt. July 17, 1995) (hereinafter "Order on Appeal"), and in his subsequent "Ruling on Motion for Clarification." In re St. Johnsbury Trucking Co., Inc., No. 2:94CV322, slip op. (D.Vt. Aug. 11, 1995).

***2** Neither ruling, however, explicitly determined Sanctions Parties' prior motions with respect to our Turnover Order, although it was arguable that they had done so. Although our preference and intention is to enforce the Turnover Order as soon as we are able, it was not clear that Judge Murtha had freed us to move ahead. Not wishing to sandbag either our new Chief Judge or the parties, we refrained from acting while threatening to do so, which proves in retrospect to have been wise. The Sanctions Parties went back to Judge Murtha and got clarification of his intent with respect to their pending motions as to our Turnover Order. In his "Ruling on Emergency Motion for Stay Pending Appeal," Judge Murtha stated:

[I]t was not this Court's intention to issue a ruling on any petition for writ of mandamus ... which calls into question the propriety of Judge Conrad's original order requiring allegedly privileged documents to be turned over to sanctions counsel.... In fact, on the present record, the Court was under the impression that Judge Conrad had superseded his first order requiring the submission of documents to [Sanctions Counsel] when he issued the subsequent order requiring those same documents be turned over to Judge Marro.

....

[T]he Court could discern no reason why Judge Conrad would simultaneously order an in camera review and require those same documents be turned over to [Sanctions Counsel].

In re St. Johnsbury Trucking Co., Inc., No. 2:94CV322, slip op at 2-3 (D.Vt. Aug. 17, 1995) (hereinafter "Remand Order"). Accordingly, Judge Murtha remanded the matter to us, directing that we "reconsider the extent to which [our Turnover Order] has been superseded or whether [our Turnover Order] requiring the [Sanctions Parties] to produce documents to [Sanctions Counsel] should be stayed pending the outcome of Judge Marro's review" under our In Camera Order. Id. at 6 (D.Vt. Aug. 17, 1995). For the reasons that follow, we believe that our Turnover Order should be enforced as entered.

[1][2][3][4][5][6][7] There are, as we write, 24 cartons of allegedly privileged documents

stacked along two walls of the office of Senior Bankruptcy Judge Marro. To review these materials in camera will require that Judge Marro spend countless hours reviewing thousands of pages of documents one page at a time. The process will also require, or at least produce, extensive briefing before Judge Marro, and appeals will proliferate. Although this is an exercise that he has consented to undertake, we believe that to have him do so is an unnecessary step that prolongs these proceedings and increases costs without good reason. Our In Camera Order discussed at some length the law and facts that lead us to conclude that our Turnover Order was proper and should be enforced. [FN3] The discussion that follows is an abbreviated recapitulation of the points made there. The chain of reasoning which leads us to the conclusion that the Turnover Order was appropriate and should be enforced is as follows:

***3** 1. Claims of communication privilege [FN4] are subject to the "Exception for Prospective or Ongoing Crime or Fraud." [FN5]

2. Where the Exception [FN6] applies, we are authorized to order the turnover of documents that would otherwise be privileged.

3. Application of the Exception requires "that a prudent person have a reasonable basis to suspect the perpetration or attempted perpetration of a crime or fraud, and that the communications were in furtherance thereof." [FN7]

4. The Exception applies not only to garden-variety crimes and frauds, but also to fraud on the court.

5. A fraud on the Court "occurs when it can be demonstrated, clearly and convincingly, that a party has sentiently set in motion some unconscionable scheme calculated to interfere with the judicial system's ability impartially to adjudicate a matter by improperly influencing the trier or unfairly hampering the presentation of the opposing party's claim or defense." Aoude v. Mobil Oil Corp., 892 F.2d 1115, 1118 (1st Cir. 1989).

6. Filing of an objectively unreasonable pleading for an objectively improper purpose that results in extraordinary costs to the Court and other parties constitutes a fraud on the Court. In Camera Order, supra, 184 BR at 453.

7. BT's Counterclaim was an objectively unreasonable pleading filed for an objectively improper purpose that resulted in extraordinary costs to the Court and other parties. Alternatively, a prudent person would reasonably suspect such to be the case.

We believe that if each link in our chain of reasoning is correct it follows ineluctably that the Turnover Order is correct and should be enforced. Our rationale for each of the links in our chain of reasoning is set out in the In Camera Order. Links 1-4 are well-settled law, and

require no further explication. Link 5, although stating a principle that not many courts have addressed, seems to us to be common sense and uncontroversial. Moreover, we understand Judge Murtha to have upheld us on this point. See, his "Ruling on Emergency Motions for Stay and Emergency Motion for Leave to Appeal," No. 2:94CV322 at 2 (July 27, 1995). Our conclusion in Link 7 is, we believe, abundantly supported by the evidence, and we see no need to belabor the point.

[8] Link 6 contains the only new or novel legal reasoning. Accordingly, we briefly add to our discussion of the subject in the In Camera Order. The law as to what constitutes a fraud on the Court is not as clearly defined by precedent and authority as other matters discussed in our In Camera Order. Accordingly, we canvassed what material we could find on the subject, which established that fraud on the court need not involve a technical civil crime or fraud. In Camera Order, supra, 184 BR at 456. We felt it important, however, not to use definitional imprecision in the law as an occasion to stretch the crime-fraud exception beyond its proper purpose.

We believe that the principle served by both the attorney-client privilege and the crime-fraud exception is that communications in furtherance of some sufficiently malignant purpose will not be protected. In determining whether to uphold the privilege, we should look to substance, not form. Thus, for example, it makes no sense and doesnot further the policy behind the privilege or its exception to protect communications in situations like the present case or to deny protection in trivial cases of technical crimes.

***4** In Camera Order, supra, 184 Vt. at 456. The test we adopted derives from well-settled principles applied in sanctions proceedings under Fed.R.Civ.P. 11, but is significantly more limited in its scope, reaching only seriously abusive conduct. [FN8] Accordingly, we believe that the Turnover Order was proper and appropriate when issued [FN9] and should be enforced.

FN1. Our subject matter jurisdiction over this controversy arises under 28 USC §1334 (b) and the General Reference to this Court under Part V of the Local District Court Rules for the District of Vermont. This is a core matter under 28 USC §§157(b)(2)(A), (O) and (O). This Memorandum of Decision constitutes findings of fact and conclusions of law under F.R.Civ.P. 52, as made applicable by F.R.Bkrtcy.P. 7052.

FN2. The conduct in question is BT's prosecution of "what appeared to be a bogus counterclaim as a sword and shield to thwart the determination" of this adversary proceeding, and "to force a cash-strapped, litigation-weary Debtor to settle the adversary proceeding and the main case on its terms." In Camera Order, supra, 184 BR at 451.

FN3. We were aware that the Sanctions Parties' motions for leave to appeal, for a stay,

and for a writ of mandamus in connection with the Turnover Order were still pending at the time the In Camera Order was issued, and used the occasion to clarify our views on the underlying matters.

FN4. The discussion that follows assumes the claim of privilege has merit. As noted in our In Camera Order, it is not at all clear that some of the matters claimed to be privileged are in fact privileged. Examples of questionable privilege cited in the In Camera Order were communications between BT and O'M&M related to O'M&M's potential malpractice liability. In Camera Order, supra, 184 BR at 453-54.

FN5. The name we give to the Exception is that used by the Second Circuit in In re Grand Jury Subpoena Duces Tecum, supra, 731 F.2d at 1038.

FN6. As we noted in our In Camera Order,

[T]he attorney-client privilege "applies only where necessary to achieve its purpose." Fisher v. U.S., 425 U.S. [391, 403, 96 S.Ct. 1569, 1577, 48 L.Ed.2d 39 (1976)] Thus, the exception is not really an exception but an "exclusion," In re Grand Jury Subpoena, supra, 731 F.2d at 1038, representing not an inroad upon the privilege, but a limit on its reach.

In Camera Order, supra, 184 BR at 456.

FN7. Judge Martin relied on In re John Doe, 13 F.3d 633, 637 (1994) for the proposition that application of the Exception requires "probable cause," stating:

It should be noted that "probable cause" is the same standard that applies in determining whether a search warrant may issue. This is entirely appropriate for in each case the result of the finding is to justify a serious invasion into matters that otherwise would remain private.

We believe that this is an egregious mischaracterization. As we noted in the In Camera Order, supra, 184 BR at 455, the Second Circuit itself has used the "prudent person" standard set out above to define what it means by "probable cause."

In In re John Doe Corp., supra, we referred to the burden on the party seeking to overcome the privilege in terms of showing probable cause to believe that a crime or fraud had been committed and that the communications were in furtherance thereof. Other circuits have referred to the burden in terms of the need to make a prima facie showing. As a practical matter, there is little difference here between the two tests. Both require that a prudent person have a reasonable basis to suspect the perpetration or attempted perpetration of a crime or fraud, and that the communications were in

furtherance thereof.

In re Grand Jury Subpoena Duces Tecum, supra, 731 F.2d at 1039 (1984) (citations omitted). We believe Judge Martin erred in equating searches requiring a warrant with incursions into the attorney-client privilege. The former is a matter of constitutional right, U.S. Const., fourth amendment; the latter is a grudging concession to the need to "encourage clients to make full disclosure to their attorneys" that "applies only where necessary to achieve its purpose." Fisher v. U.S., supra, 425 U.S. at 403-04, 96 S.Ct. at 1577, 48 L.Ed.2d at 51. Indeed, we suggest that it would be a useful appellate exercise to require the Sanctions Parties to explain with particularity just how it is that the disputed communications served the purposes of full disclosure by clients to their attorneys. To the extent they are unable to do so, the privilege is inapplicable.

FN8. We held that the "confluence" of three elements -- "an objectively unreasonable pleading" that was "filed for an objectively improper purpose" and that "imposed extraordinary costs upon the Debtor's estate, its creditors, and the Bankruptcy Court," would constitute "not just sanctionable conduct under Rule 11, but, we believe, amounts to fraud upon the court." In Camera Order, supra, 184 BR at 452-53.

FN9. The continuing efforts of Sanctions Counsel may have led to new grounds for ordering turnover, based on ongoing garden-variety fraud, which in the context of this Sanctions Proceeding may also constitute fraud on the court. BT and O'M&M now concede knowledge that accounts receivable records were located in Vermont, but argue that very knowledge made reliance on the representation reasonable because it told them where the "controlling" records were located. Our thoughts on the overt speciousness of this argument appear in the In Camera Order, supra, 184 BR at 456-58. Sanctions Counsel's "Report on Investigation of Non-Privileged Materials," 32-54, suggests that the Sanctions Parties have, in pleadings and depositions subsequent to the Turnover Order, systematically misrepresented the truth with respect to their reliance under this theory. Indeed, Sanctions Counsel reports that it appears there was no reliance, reasonable or otherwise, but rather

a failure on the part of Bankers and its lawyers to consider either the facts in their possession or the potential application of Vermont law.

A more complete review of the record further indicates that the testimony provided by Bankers' witnesses was largely developed after the fact, and is not based on the witnesses' own memories.

Sanctions Counsel's Report, 51. We acknowledge that the Sanctions Parties have not had a full and sufficient opportunity to respond to Sanctions Counsel's Report. Nevertheless, the Report leads us to conclude beyond peradventure that the veil of the

attorney-client privilege should be pulled aside in order to have a full and fair hearing on the events which have transpired.

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