UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

In re

TREMONT CORPORATION — Case No. 89-12201 K

Debtor

DOUGLAS MARKY, as Trustee of
Tremont Corporation

Plaintiff

-vs- — AP 91-1341 K

FLEET BANK OF NEW YORK,
NATIONAL ASSOCIATION

Defendant

DANIEL F. BROWN, ESQ.
DAMON & MOREY
1000 Cathedral Place
298 Main Street
Buffalo, New York 14202-4096

Special Counsel for the Trustee

JANET G. BURHYTE, ESQ.
JAECKLE, FLEISCHMANN & MUGEL
Norstar Building, Twelve Fountain Plaza
Buffalo, New York 14202-2292

Attorneys for Defendant

The current matters are set against a backdrop of an Adversary Proceeding by which the Chapter 7 Trustee of Tremont Corp. seeks to set aside $800,000 of a mortgage on the debtor's property, which mortgage was granted on September 19, 1988. These matters offer the foreboding image of this Court's falling prey to

those who would rather litigate sanctions than merits.

Here consolidated for purposes of decision are two motions filed by the mortgagee Defendant Fleet Bank by which it seeks sanctions. In each, Fleet seeks either (1) dismissal of the Adversary Proceeding, or (2) an order precluding the Plaintiff-Trustee from offering evidence pertaining to an essential element of the Plaintiff's Causes of Action (thus effectively dismissing the Complaint). Although Fleet's motions contain the usual alternative prayer for "such other and further relief as the Court deems proper," it is clear that Fleet would not be happy with less than dismissal or preclusion.

The two motions are based on the same operative facts and are otherwise entwined. Thus they are here consolidated for decision and will be discussed separately, except in Part III -- Conclusion.

Although based on other provisions of law as well, they will be referred to herein as the "Rule 11 Motion" and the "Rule 37 Motion."

These matters must be set out in considerable detail below, for they are weighty matters -- weighty in the burdens they have needlessly placed upon this Court -- deserving of a complete record.

In capsule form, the facts are these. (All "findings of fact" contained herein are such only for purposes of the current

motions, and not for purposes of the underlying litigation.) In the spring of 1991, a bank turned over documents to a trustee under Bankruptcy Rule 2004. Among them was a 1987 tax return of the debtor corporation. Schedule L thereof was a balance sheet reporting the corporation to be insolvent by $3.3 million dollars on Dec. 31, 1987 (presuming the accuracy of the return and the information upon which it was based). A copy of Schedule L is appended to this Decision. In the summer of 1991, the Trustee's counsel took note of the tax return. On Dec. 2, 1991 the Trustee commenced this Adversary Proceeding against the bank, seeking to set aside a Sept. 19, 1988 mortgage taken by the bank: an essential element of each cause of action in the Complaint is that the debtor have been insolvent on 8/19/88 or that it have been rendered insolvent by the grant of that mortgage.

By June of 1992, the Trustee's counsel (a law firm) had institutionally "forgotten," or misplaced the records of, the 1987 tax return, and thus caused the Trustee to sign Responses to Defendant's Interrogatories which Responses nowhere cited that return as a basis for the Trustee's allegation of insolvency.

The bank, either institutionally "forgetting" or choosing to ignore the fact that it had turned over to the Trustee the tax return (one possible evidentiary basis for the allegation of insolvency), filed a motion under Rule 11 claiming, inter alia, that the Trustee had falsely certified that the Complaint was

factually well-grounded, given that his answers to interrogatories offered no hard or concrete evidence of insolvency. The motion seeks dismissal of the Adversary Proceeding, or an order precluding the offer of any evidence of insolvency.

After enormous expenditure of money and time on all sides in addressing that motion, the Trustee's counsel rediscovered the 1987 tax return and evidence of the firm's 1991 analysis thereof, whereupon the bank filed a motion under Rule 37 praying for dismissal or preclusion, claiming that that information had been knowingly withheld from the Responses to Interrogatories.

Thus, what is at Bar is either a bizarre comedy of errors, or it is a circle of deception that advances the litigation not one iota and does a disservice to this Court and the community it serves.

The bank's motions are denied.

PART ONE. THE RULE 37 MOTION

A. SUMMARY OF FACTS

First to be examined here is a motion alleging discovery abuse and seeking sanctions under Rule 37 of the Federal Rules of Civil Procedure, which is incorporated into Adversary Proceedings

in bankruptcy by Bankruptcy Rule 7037. The motion is brought by Fleet Bank of New York, which is the defendant in this Adversary Proceeding. The plaintiff is the Chapter 7 Bankruptcy Trustee of Tremont Corporation, and in this proceeding he seeks to establish that an $800,000 mortgage granted to Fleet's predecessor in interest upon Tremont's property should be set aside or subordinated as, inter alia, a fraudulent transfer.

The mortgage in question was recorded on September 19, 1988, and each cause of action asserted in the Trustee's Complaint of Dec. 2, 1991 alleges, as a necessary element, that Tremont Corporation was either insolvent on that date or was rendered insolvent by that transaction. These allegations of insolvency are a major area of dispute, and denial of insolvency is a cornerstone of the defense.

Fleet's motion sets forth its efforts to obtain discovery on the issue of insolvency. These efforts, and their results, will be capsulized in the following section of this decision. By July 13, 1992, Fleet was convinced of one of two things: either Fleet had forgotten about the 1987 Tremont Corp. tax return which it had turned over to the Trustee a year or more earlier and was convinced that the plaintiff had no evidence of insolvency and that he never had such evidence, or Fleet remembered the tax return but was convinced that it had "gotten lucky" -- that the Trustee had missed the fact that the tax return reporting insolvency on December 31,

1987. Breaking new ground as to practice in this Court, it filed a motion under Rule 11 of the Federal Rules of Civil Procedure (a version of which is adopted by Bankruptcy Rule 9011). Fleet sought to dismiss the Complaint as a sanction for failure, inter alia, to make a reasonable inquiry into the facts regarding the question of solvency, and for consequent violation of the Rule 11 admonition that a signature constitutes a certification of the Plaintiff's belief that the Complaint is well-grounded in fact and is not filed for improper purpose. A hearing was conducted by the Court into the question of what evidence the Trustee had of insolvency prior to or on December 2, 1991 (the date this adversary proceeding was commenced). At that hearing, the Trustee was permitted (over Fleet's objection) to present a tax accountant as an expert witness. The accountant testified to a meeting of which he was part at the office of the Trustee's counsel, the firm of Damon & Morey, in the summer of 1991 (prior to the filing of the Adversary Proceeding in this case). He testified that at that meeting he explained to certain members (and at least one associate) of the firm why he believed that the 1987 tax return of Tremont Corporation, obtained in a turnover of documents from Norstar Bank (the predecessor of Fleet), demonstrated the insolvency of Tremont Corporation as of December 31, 1987. This testimony was offered to establish that the Trustee and his counsel had indeed made reasonable inquiry into the facts, and had appropriately certified

their belief that the current Complaint was well-grounded in fact. Fleet now asserts that this testimony conclusively establishes that the Trustee or Damon & Morey falsely or evasively answered certain Interrogatories by which Fleet had attempted to ascertain the basis of the plaintiff's allegation of insolvency, the Responses to which made no mention of the 1987 tax return or of the accountant.

Thus, Fleet seeks, by the present Rule 37 motion, to dismiss the Complaint or to preclude the plaintiff's introduction of any evidence on the issue of insolvency (which preclusion would be tantamount to dismissal of the Complaint), or monetary or other sanctions, in light of what Fleet asserts is a wilful withholding of information.

The response to the motion rests essentially in declarations of various partners and associates in the firm of Damon & Morey to the effect that the Interrogatories were properly answered; but if not, they argue, then any omission or error was not intentional and should not result in the harsh sanctions sought by Fleet because the problem lay in a failure of intra-firm communications and co-ordination. Further, they argue that since the 1987 tax return had been obtained from Fleet's predecessor in the first place, Fleet could not be surprised by any evidence in regard thereto and should not be entitled to sanctions.

Fleet further and similarly moves under Rule 37 regarding the plaintiff's failure to reveal in Responses to the First Set of

Interrogatories, the identities of forty-five persons whose names were disclosed later in response to Fleet's Second Set of Interrogatories.

B. HOLDING

The Court finds that any Rule 37 violation that might have occurred was di minimus; that even if any significant violation occurred, neither dismissal nor preclusion are appropriate, as discussed hereinafter; and that the Rule 37 motion is, therefore, denied.

C. CHRONOLOGY OF EVENTS

In the spring of 1991, Fleet's predecessor turned over to the Trustee, in a Bankruptcy Rule 2004 examination, a copy of Tremont Corporation's 1987 federal tax return, which the bank had examined in 1988. (Transcript of Deposition of Jeffrey P. Lehrbach, 11/18/92, p. 65.)

In the summer of 1991, attorneys Savino, Kanaley and Lombino of Damon & Morey, while the firm was special counsel to the Trustee, met with Accountant Vincent Ferraro, at which time Ferraro told them that the 1987 tax return of Tremont obtained from Fleet, showed Tremont to have been insolvent as of December 31, 1987.

Lombino left the firm shortly thereafter. The following further occurrences are recited by the parties.

On December 2, 1991, the Trustee commenced this Adversary Proceeding by Complaint alleging three causes of action attacking debtor Tremont Corporation's transfer of a mortgage to Norstar Bank on September 19, 1988. The first cause of action alleges that the transfer was a fraudulent transfer, the second attacks the transfer as a so-called "DiPrezio"-type preferential transfer for the benefit of Tremont's principal officer, James J. Michalek[1], and the third alleges that the bank's lien should be subordinated to unsecured creditors under 11 U.S.C. § 510 as a penalty for inequitable conduct.

A Scheduling Order was entered initially fixing June 30, 1992 as the discovery deadline.

On April 15, 1992, Norstar's successor, Fleet Bank, served its First Set of Interrogatories.

On June 8, 1992, Senior Associate Daniel Brown, Esq. of the Damon & Morey firm, met with Ferraro, the accountant, but (according to their attestations) did not have occasion to discuss, and did not discuss, whether Tremont was insolvent or not.

---

[1]For an explanation of this type of cause, recognized only by some courts, see *Levit v. Ingersoll Rand Finance*, 874 F.2d 1186 (7th Cir. 1989). Whether such a cause is recognized in this jurisdiction has not yet been decided.

On June 12, 1992, Responses prepared by Damon & Morey, to the First Set of Interrogatories, were filed. They were silent as to the 1987 tax return and as to Ferraro.

On June 16, 1992, Fleet's counsel advised Damon & Morey of deficiencies they perceived in the Responses to Interrogatories but made no mention of the 1987 tax return that Fleet itself had turned over. On June 25, 1992, the Trustee filed Revised Responses to the Interrogatories. These too were silent as to the 1987 tax return and Ferraro.

After examining these Revised Responses, Fleet filed on July 13, 1992, its motion under Rule 11, seeking to dismiss the Complaint on the grounds that the Responses to the Interrogatories demonstrated that the Trustee had no factual basis for the allegation of insolvency of Tremont. (The Court has no evidence as to whether Fleet or its counsel, the firm of Jaeckle, Fleischmann & Mugel, Janet Burhyte Esq. of Counsel, "recalled" (as of July 13, 1992) Fleet having turned over the 1987 tax return containing a balance sheet that on its face reported insolvency.) (See the Appendix to this decision.)

On July 15, 1992, the Trustee's response to the Rule 11 motion was filed; the response made no mention of the 1987 tax return or of the opinion which Ferraro had given the firm of Damon & Morey regarding what the tax return contained relative to the insolvency of Tremont.

On August 26, 1992, the Court entered an Order denying the Rule 11 motion.

On September 8, 1992, Fleet filed a motion asking that the Court reconsider its order denying the Rule 11 motion.

On September 22, 1992, an ongoing deposition of the Trustee by Fleet continued and the Trustee and his counsel made no mention of the 1987 tax return or the Ferraro opinion. Nor did Fleet.

On September 29, 1992, Fleet served a Second Set of Interrogatories.

On September 30, 1992, a hearing was conducted in regard to the motion to reconsider the order denying the Rule 11 motion. Again, no disclosure to the Court by either side.

On October 14, 1992, there was a further hearing regarding the motion to reconsider. No disclosure.

On October 19, 1992, attorney Brown acquired personal knowledge of the existence of the 1987 tax return and in a meeting with a different accountant learned that the tax return could demonstrate insolvency of Tremont as of December 31, 1987.

On October 22, 1992, the deposition of the Trustee continued and attorney Brown learned, through Fleet's interrogation of the Trustee, of Fleet's interest in any services that had been performed for the Trustee by Ferraro. However, there still was no disclosure by either side of the perceived significance of the 1987

tax return, or by the Trustee regarding the fact that Ferraro had pointed its "Schedule L--Balance Sheets" out to Trustee's counsel.

On October 23, 1992, attorney Brown talked to Ferraro and gained personal knowledge of Ferraro's having been involved in the earlier investigation of insolvency, but Brown allegedly did not on that date learn about the 1987 tax return specifically.

On October 27, 1992, Brown acquired actual personal knowledge, from Ferraro, that Ferraro had pointed out the 1987 tax return of Tremont to Damon & Morey in the summer of 1991 and learned that it contained a balance sheet reporting the insolvency of Tremont as of December 31, 1987.

On October 28, 1992, Brown and Fleet's counsel met with the Court in chambers to discuss a different discovery dispute. At that conference, Brown advised the Court and Fleet's counsel that at the continued hearing on reconsideration of the Rule 11 motion, scheduled for November 4, 1992, Brown intended to call Ferraro. Fleet's counsel objected, and the Court indicated that it would rule on the objection at hearing.

On November 2, 1992, the Trustee filed responses to the Second Set of Interrogatories. These responses for the first time identified Ferraro as a person who might have familiarity with some assets and liabilities of Tremont and Tremont's alleged insolvency and lack of capitalization.

On November 4, 1992, the further hearing on the motion to

reconsider was conducted, at which Ferraro was called and testified, over Fleet's objection,[2] to the effect set forth above.

The present motion seeking dismissal or a preclusion order and sanctions under Bankruptcy Rule 7037 was filed by Fleet on November 13, 1992.

D. THE TRUSTEE'S RESPONSES

As to the forty-five names, the Trustee argues simply that the First Set of Interrogatories did not request them. Damon & Morey's explanation of the delay in coming forth with the fact of the Trustee's reliance on the 1987 tax return is contained in the separate Declarations of William F. Savino, Esq. (a partner with the firm), Daniel F. Brown, Esq. (an associate), and Michael J. Russo, Esq. (an associate).

Savino (who attended the 1991 meeting with Ferraro) explains the extent of his personal involvement in bankruptcy files he supervises generally, and in this case in particular. He also explains the involvement of other past or present members or employees of the firm in this case.

---

[2]Despite the delay in offering Ferraro, the Court permitted Ferraro's testimony to be taken for a precisely limited purpose: to make a complete record for purposes of review, if this Court were to choose to preclude Ferraro's testimony when rendering a decision on the Rule 11 motion.

Brown and Russo explain the preparation of the Responses to the First Set of Interrogatories and explain how and when they gained actual personal knowledge of the information in question.

As reflected in the Trustee's Opposition (signed by Brown for himself and Savino), the sum total of these declarations is Damon and Morey's assertion that if there was any failure to disclose information, it was a mistake, a wholly inadvertent and honest mistake that did not prejudice Fleet's defense; they argue that dismissal or preclusion, therefore, would be inappropriate and must be denied.

E. THE FORTY-FIVE NAMES

Addressing Fleet's second concern first, Fleet claims that the Trustee's failure to reveal, in response to the First Set of Interrogatories, the identities of forty-five persons and entities which the Trustee believes might have knowledge of the facts relating to the insolvency issue, warrants an order precluding the Trustee from offering any of those persons as witnesses at trial, and such other and further relief as the Court deems just and proper.

The Court disagrees. The questions asked in the Second Set of Interrogatories were categorically and manifestly different from those asked in the First Set. Accordingly, the Court finds

that those names were not required to be produced in response to the First Set of Interrogatories.

The Court will not needlessly prolong this decision by setting out the five pages of "Definitions" and "Instructions" which preface the fourteen further pages of Fleet's First Set of Interrogatories and Requests for Production, even though an understanding of those prefatory materials is necessary to a complete understanding of the pertinent interrogatories. Suffice it to say that interrogatories four, five, six, seven, eight, and nine of the First Set of Interrogatories together requested that the Trustee identify and summarize the evidence he has regarding the debtor's assets and liabilities, and the values thereof, on various dates and on September 19, 1988 or immediately before or after. Interrogatory numbers ten and eleven of the First Set asked that the Trustee set forth the basis for his contention that the debtor was insolvent on September 19, 1988, or that the debtor was made insolvent or became insolvent as a result of the transfer on that date.[3]

---

[3]The Trustee responded to the effect that the debtor's schedules and certain extrinsic evidence since the bankruptcy filing suggested that the debtor was insolvent as of the commencement of the case. He explained some of this information, and specifically in response to interrogatory numbers 10 and 11 stated: "additional discovery is necessary to obtain detailed information regarding the solvency of the debtor as of the time of the transfer." Thus he set forth no "hard facts," but did produce documents.

The Second Set of Interrogatories was different, and it is in examining the difference that it can be seen why disclosure of the forty-five names was not required in response to the First Set of Interrogatories. Each of the Interrogatories contained in the Second Set begins "Identify each witness having knowledge of facts or information, or possessing any information or documents, relating to ...." "Witness," however, is not a "defined" term.

In light of the difference, it is clear that the First Set of Interrogatories asked the Trustee for the basis of his allegations.

The Second Set of Interrogatories, on the other hand, did not request information specific to the Trustee's support for his case in chief. It asked, in essence, for the names of those who he knew or believed had useful information.

Thus, in the Trustee's papers opposing this Rule 37 Motion, he stated:

> "Defendant's Motion appears to presume, that, in preparing Plaintiff's Responses to Defendant's First Set of Interrogatories, Plaintiff based its [sic] Responses upon information obtained from those individuals named in response to Defendant's Second Set of Interrogatories. In most cases that is simply not true... In those cases where this was true, Plaintiff's Responses to Defendant's First Set of Interrogatories and Requests for Production provided copies of all appraisals, bankruptcy schedules, etc. relied upon by the

> Plaintiff in the preparation of its Responses to Defendant's First Set of Interrogatories... The vast majority of those people identified in Plaintiff's Responses to Defendant's Second Set of Interrogatories, however, were not bases for any statement contained in Plaintiff's Responses to Defendant's First Set of Interrogatories, although documents identifying those individuals were produced...."
>
> Trustee's Reply at 21.

The Trustee is correct. In the Court's view, the First Set of Interrogatories asked for the evidence possessed by the Trustee in pertinent regards. The identity of persons possessing that information was required to be disclosed if the Trustee had derived evidence from those individuals. The Second Set of Interrogatories asked a much broader question -- i.e., "Tell us who you think might have evidence, whether you have relied on those persons or not." It appears that the answers he provided to the Second Set were appropriate. If Fleet's own Interrogatories were overly broad, it cannot now complain that a proper response leaves it with many areas of inquiry.[4]

Furthermore, as stated by the Trustee, Fleet has not asserted that even one of these forty-five names comes as a surprise, or that the knowledge that they might have information regarding the solvency or insolvency of the corporation would be a

---

[4]If Fleet's intent was to obtain the identity of the witnesses the Trustee intended to call, it was an inappropriate effort.

surprise. Nor has Fleet requested an extension of the discovery deadline in order to explore these opportunities.

Rule 37 was not violated with regard to the responses to the First Set of Interrogatories in regard to these forty-five names.

F. THE 1987 TAX RETURN

Fleet claims that the Trustee should have disclosed, in the Responses to the First Set of Interrogatories, his reliance on the view that the 1987 tax return demonstrated insolvency as of December 31, 1987, and that a certified public accountant had so advised Damon and Morey (the Trustee's legal counsel).

It is helpful to assess the importance this information may have had if those disclosures had been made. The tax return or Ferraro opinion do not seem to be a "smoking gun." Disclosure does not seem likely to have provided Fleet with the key piece of information it needed to prepare its case or to prove its defense. Nor, on the other hand, does it seem to be the fatal piece of information that might cause Fleet to try to settle the matter.

Rather, it seems likely that if the plaintiff had disclosed this information, the impact on this adversary proceeding would have been di minimis. The tax return had been in the possession of Fleet and had been turned over to the Trustee by

Fleet prior to the commencement of this adversary proceeding. It was no surprise to Fleet Bank and in fact was examined by a Fleet officer. Because a balance sheet filed as part of a tax return speaks for itself, the fact that it happened that an expert retained by the Trustee was the one who pointed out the existence of the document is irrelevant for discovery purposes. (For Rule 11 purposes it is important that it be shown that someone did in fact bring the document to the attention of the Trustee or his counsel prior to the filing of the Complaint, as discussed later.)

What charged that "oversight" or "omission" with great moment was the perception on the part of Fleet that no "concrete evidence" of insolvency was disclosed by the Trustee at all, and Fleet took this to signify that as of June, 1992, the Trustee had no evidence with which to prove insolvency at trial. If Fleet had "forgotten" about turning over the tax return, then it must have believed that in fact the Trustee had lacked any factual basis in filing the Complaint; but if that is the case, then its persistence in this matter now is problematic, for it is complaining of the same type of error it committed itself when it filed the Rule 11 motion -- "misplacing" or otherwise losing information. If Fleet had not "forgotten," then it sought to gain the advantage of a Rule that was intended for a very different purpose. In any event, it asked the Court to dismiss the Complaint under Rule 11.

Then further omissions occurred. Had the Trustee and his

counsel, upon being served with the Rule 11 motion, promptly said to themselves "Now a different issue is being raised. Let's review our records and provide the Court and the Defendant with the factual basis of our decision, back in 1991, to file the Complaint, and then explain how that is distinguishable from what we thought the Defendant asked for in the interrogatories," and had the Trustee then appeared on July 21, 1992 in response to the Rule 11 Motion and simply stated that the 1987 tax return was a principal basis of the decision to file the Complaint, the present dispute would likely have ended there (except for a possible cross-motion against Fleet seeking sanctions against Fleet for having complained of a lack of factual basis when Fleet itself knew of and had turned over to the Trustee, one such basis).

Instead, the facts regarding the tax return were not disclosed to the Court by either party. The parties briefed the Rule 11 issue; the Court had to take the Rule 11 Motion under submission; the Court wrote and entered against Fleet a decision on the motion; Fleet filed a motion to reconsider; the Court entertained that motion; the parties briefed that motion; and the Court held hearings. All of this was suffered <u>before</u> anyone came forward with this potentially-decisive information (for Rule 11 purposes); it was the Trustee's counsel who did so during an in-chambers conference regarding a <u>different</u> discovery dispute. During the same period, Fleet was in regular communication with the

Trustee and his counsel outside of Court, and indeed Fleet deposed the Trustee on several occasions.

Thus, an omission that is of di minimis significance in the case proper, was needlessly elevated to great importance in the context of Rule 11 and the motion to dismiss based thereon.

That the Rule 11 motion was filed despite Fleet's use and turnover of the 1987 tax return was either "innocent" error or gross overreaching by Fleet or its counsel. That that motion was not answered swiftly and decisively by disclosure of the tax return is clear error on the part of the Trustee's counsel. Both parties are at fault for the burdens they have placed upon one another and this Court.

The Court is further troubled by the fact that the relief sought by Fleet and its counsel flies in the face of clear precedent that is binding upon this Court.

In *Outley v. City of New York*, 837 F.2d 587 (2d Cir. 1988), the Court warned trial courts as follows, regarding Rule 37:

> Before the extreme sanction of preclusion may be used ..., a Judge should inquire more fully into the actual difficulties which the violation causes, and must consider less drastic responses. 'Considerations of fair play may dictate that Courts eschew the harshest sanctions ... where failure to comply is due to a mere oversight of counsel amounting to no more than simple negligence.'"

837 F.2d 587, at 591.

The Court offered a warning to litigants as well:

> The rules of discovery were not designed to encourage procedural gamesmanship, with lawyers seizing upon mistakes made by their counterparts in order to gain some advantage. The [moving party] sought the most drastic remedy, preclusion, rather than requesting a recess or continuance ... 'Courts have looked with disfavor upon parties who claim surprise and prejudice but who do not ask for a recess ...'."

837 F.2d 587, at 590 [citations omitted]. (If, when Fleet filed its Rule 11 motion, Fleet was fully aware of the fact that it had given the 1987 tax return to the Trustee, then Fleet's disregard of the Second Circuit's warnings was nothing less than brazen.)

In the case of *Cine Forty-Second Street Theater Corporation v. Allied Artists Pictures Corporation, et al.*, 602 F.2d 1062 (2d Cir. 1979), on the other hand, the Court held that the lower court had erred in failing to preclude certain evidence. It stated that

> "where gross professional negligence has been found - that is, where counsel clearly should have understood his duty to the Court - the full range of sanctions may be marshalled. Indeed, in this day of burgeoning, costly and protracted litigation Courts should not shrink from imposing harsh sanctions where, as in this case, they are clearly warranted." Id. at 1608.

While the *Cine Forty-Second Street* Case must not be misread as requiring a finding of "gross professional negligence"

before the harsh sanctions of dismissal or preclusion would ever be warranted, it is important to note that the respondent in that case (unlike the Trustee here) had failed to obey two orders from a Federal Magistrate-Judge compelling discovery, and further ignored that Magistrate's warning that any further non-compliance would result in dismissal. The Circuit Court cited the parties to dictum in the case of *SEC v. Research Automation Corporation*, 521 F.2d 585 (2d Cir. 1975). In that earlier case, the Court reversed a grant of default judgment applied as a sanction for failure to refuse to be sworn to testify at deposition. The Research Automation Court stated that "We hold that under these circumstances, unless the plaintiff further obtains a court order pursuant to Rule 37(a), F.R.Civ.P., directing the defendant to testify, the Court lacks the power to impose this severe sanction." Id. at 586. The Court went on to state that a default judgment granting relief against the defendant for failure to cooperate in pre-trial discovery is "a harsh sanction, which must be cautiously used ... lest the resulting grant of relief amount to a deprivation of property without due process." Id. at 588. It appears that the "dictum" to which the *Cine Forty-Second Street Theater* court was referring is this:

> "Recognizing the severity of the sanction of a judgment granting affirmative relief by default, we have held that, notwithstanding the elimination of the term 'wilful' from Rule 37 as a result of the 1970 amendments, the

> sanction should not be imposed because of negligence, and that the plaintiff must demonstrate that the defendant's failure to comply is due to wilfulness, bad faith or fault and not to an inability to comply." Id. at 588.

Thus, whereas the *SEC v. Research Automation Corporation* court addressed the entry of default judgment as a sanction, the *Cine Forty-Second Street Theater* court placed similar constraints on the use of the next most harsh sanction, that of preclusion.[5]

Finally, no trial court may ignore the clear solicitude expressed by the United States Supreme Court for the exercise of restraint in applying the harshest of discovery sanctions.[6]

In light of the above authorities, Fleet's reliance on cases from other jurisdictions is unavailing, and is distressing in light of case law that binds this Court.

I find that if there was any failure to properly respond to the First Set of Interrogatories, it was either di minimus or was not wilful and not a product of gross professional negligence,

---

[5]As indicated above, preclusion of evidence of insolvency in the case at bar would be tantamount to dismissal, since insolvency is an essential element of each of the three causes of action.

[6]The Court in *National Hockey League v. Metropolitan Hockey Club, Inc.*, 427 U.S. 639 (1976) upheld dismissal as a sanction for bad faith disobedience of a discovery order once the Supreme Court satisfied itself that the trial court did not abuse discretion in concluding that there had been "flagrant bad faith" and "callous disregard" of the responsibilities of counsel.

was not "flagrant bad faith" or "callous disregard" of counsel's responsibility and does not warrant dismissal, preclusion, or any other relief.

G. RULE 37 RESULTS

The Rule 37 motion is denied in full.

PART II

RECONSIDERATION OF THE RULE 11 MOTION

On August 26, 1992, the Court denied Fleet's Rule 11 Motion. Upon motion, the Court has reconsidered its Order of that date in light of the Court's error in believing Fleet to have agreed, on July 21, 1992, that any evidentiary showing by the Trustee would be consistent with his offer of proof of that day. A later examination of the transcript of the July 21, 1992 proceedings convinced the Court that in fact Fleet did not so agree, and on November 4 and December 9, 1992 the Court conducted an evidentiary hearing regarding the Rule 11 inquiry made by the Trustee prior to filing the Complaint in this Adversary Proceeding on December 2, 1991.

Consistent in part with the offer of proof, the testimony of the Trustee demonstrates that: He obtained appraisals of two

major parcels of real estate and found the Debtor to have overvalued them; he spoke to creditors and examined the evidences of debt held by some (bonds) and discovered that the Debtor had not scheduled accrued interest; and he determined that some substantial creditors were not scheduled.

However, the Court is deeply troubled by a major inconsistency between the Trustee's testimony and that of another witness: Assistant State Attorney General Dennis Rosen. Whereas the Trustee's Responses to Interrogatories, representations to the Court in off-the-record conferences, and recent testimony implied that the State Attorney General's use of the books and records of Tremont inhibited the Trustee's access to those records, Rosen testified that he not only never denied the Trustee or his counsel access to those records, but he was never asked for them despite having instructed the Trustee on how to obtain them.

The Court understands the Trustee to respond, basically, that regardless of what Rosen says, the Trustee did not at the time believe that the records were as available as Rosen's testimony would lead one to believe. The Trustee adds that in any event, he had turned the matter of obtaining those records over to his counsel in early or mid 1990. His counsel offers no explanation as to why the records were not subpoenaed until after this Adversary Proceeding was commenced.

The Trustee and his counsel ought to have avoided

creating the impression that their inquiry was inhibited by the State when in fact they never properly asked the State for the records. This will be further discussed later in the conclusion to this decision.

The Trustee proved one matter not raised in the offer of proof - that his counsel had been alerted by a CPA, only a few months before the filing of this Complaint, that the 1987 Tax Return of Tremont that had been turned over by Fleet contained a balance sheet that reported that Tremont was insolvent as of December 31, 1987, a date nine months prior to the transfer in question.

The issue presented is whether the Rule 11 duty to conduct a "reasonable inquiry" was satisfied.

Before considering Fleet's response to the Trustee's showing, it is necessary to address Fleet's prayer for relief. It seeks dismissal of this Complaint. It argues that dismissal is the "only appropriate sanction" for a violation of Rule 11 in this case. Fleet offers not a scintilla of authority for this proposition. While it cites authority for the proposition that dismissal may be ordered under Rule 11,[7] it ignores the fact that even some of its own authorities are to the effect that this

[7]For example, *Vista Manufacturing, Inc. v. Trac-4, Inc.*, 131 F.R.D. 134 (N.D. Ind. 1990).

harshest of remedies is to be applied only in extreme circumstances,[8] and ignores the fact that in applying sanctions, a court should apply the "least harsh remedy" that comports with the purpose of the statute.[9]

All must be mindful of the fact that Rule 11 and B.R. 9011[10] nowhere mention the word "dismissal." They speak only of an "appropriate sanction." Their purpose is to "stress the need for some prefiling inquiry into both the facts and the law... The standard is one of reasonableness under the circumstances." Advisory Committee Note to 1983 Amendment to Rule 11. [Emphasis Added.]

The 1987 Tax Return was enough under Rule 11, even if the Trustee were to have assumed that the preparer (an accounting firm) had based it upon information provided by James Michalek, who (by the time the Complaint was filed) was known to be a fraud. (Michalek has since been convicted in both State and Federal Court.) Neither the Trustee nor his counsel had reason to believe

---

[8]*Urban Elec. Supply v. N.Y. Convention Center*, 105 F.R.D. 92 (E.D.N.Y. 1985).

[9]*Neustein v. Orbach*, 130 F.R.D. 12 (E.D.N.Y. 1990).

[10]Properly, it is only Bankruptcy Rule 9011, and not F.R.Civ.P. 11, that applies in bankruptcy cases; *In Re Kamakani Services, Inc.*, 125 B.R. 819 (Bankr. D. Haw. 1991).

that the document which Ferraro pointed out was erroneous, and nothing suggested that an action against Fleet would be "patently without merit."[11] (Fleet's suggestion that a trustee in bankruptcy, a fiduciary should always be in jeopardy under Rule 11 if he fails to independently verify anything signed by, or any information provided by, a potentially dishonest "debtor" (see Bankruptcy Rule 9001(5)) before he or she may pursue receivables, preferences, fraudulent transfers, etc., would leave the trustee without the ability to rely even on the daily journals and accounts of some debtors. No system of bankruptcy could function if its fiduciaries could not rely upon a presumption that even otherwise dishonest people do not routinely commit the felonies of filing false tax returns, filing false documents with this Court, etc.)

Fleet's effort to strike Ferraro's testimony and to strike the evidence of his meeting with Damon and Morey is denied in its totality, and its Rule 11 Motion is denied. Fleet will not be permitted to ignore the factual basis that it itself handed to the Trustee, and gain advantage under Rule 11 from the fact that the Trustee and his counsel had misplaced or lost track of that same evidence. As quoted above, the Second Circuit has taught in

---

[11]See cases discussed in the August 26, 1992 decision of this Court in this matter, which decision is incorporated herein and made a part hereof. It is reported at 143 B.R. 987.

the context of Rule 37 that the rules of discovery were not designed to encourage "procedural gamesmanship, with lawyers seizing upon mistakes made by their counterparts in order to gain some advantage." Rule 11, and the processes of this Court, are not to be abused in that fashion either.

PART III

CONCLUSION

The Rule 37 Motion and the Rule 11 Motion are denied.

I have considered all other arguments of Fleet in connection with these motions, including its claim of rights under other provisions of law, and find them to be without merit.[12]

---

[12]One point deserves further attention. Fleet has repeatedly argued that the Trustee was not entitled to an evidentiary hearing to demonstrate the basis of his Complaint. It argues that since the Interrogatories offered no "facts" to support insolvency, the Trustee could have had no "facts" at the time he filed the Complaint. As the Court has repeatedly suggested to counsel, Fleet is wrong. Its counsel is admonished to read the Rule carefully. Rule 11 does not require "facts"; it requires a "belief formed after reasonable inquiry" that the Complaint "is well grounded in fact." Although a reasonable inquiry may appropriately lead to such a belief before discovery, discovery may reveal that the Complaint is without merit. (In such event, persisting in such a claim may give rise to a Rule 11 violation.) Fleet confuses itself in its insistence that there can be no "belief" of factual well-grounded"ness" without having obtained the kind of "facts" (i.e., evidence) that the plaintiff will have to produce at trial. It is by virtue of this distinction that this Court may conclude that the Trustee had a "well-founded" belief that the Complaint was well-grounded in fact, and the Court nonetheless be totally unpersuaded as to whether the 1987 tax return will be entitled to any weight at all at trial on the issue of insolvency.

The Court is at a loss for how to deal with the defendant's assertion, in both motions, of "a right" to inappropriate remedies, and with the plaintiff's lack of clarity regarding the availability of books and records that were in the custody of the State. The Court regrets the absence of a Rule that would permit sanctions against both parties, to reimburse the Federal taxpayers for the waste of this Court's time. The parties will bear their own costs.

SO ORDERED.

Dated: Buffalo, New York
January 5, 1993

U.S.B.J.

Form 1120S (1987) TREMONT CORPORATION 16-1208752 Page 4

Schedule L Balance Sheets

Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1 Cash		33,269.		5,846.
2 Trade notes and accounts receivable				
a Less allowance for bad debts				
3 Inventories		1,480,616.		1,656,811.
4 Federal and state government obligations				
5 Other current assets (attach schedule)	STMT 2	254,121.		144,798.
6 Loans to shareholders		176,991.		NONE
7 Mortgage and real estate loans				
8 Other investments (attach schedule)				
9 Buildings and other depreciable assets	1,910,323.		2,220,256.	
a Less accumulated depreciation	197,916.	1,712,407.	330,607.	1,889,649.
10 Depletable assets				
a Less accumulated depletion				
11 Land (net of any amortization)		124,624.		189,310.
12 Intangible assets (amortizable only)	423,195.		419,658.	
a Less accumulated amortization	73,597.	349,598.	99,419.	320,239.
13 Other assets (attach schedule)				
14 Total assets		4,131,626.		4,206,653.
Liabilities and Shareholders' Equity				
15 Accounts payable		104,129.		201,095.
16 Mtges., notes, bonds payable in less than 1 year		773,640.		3,238,136.
17 Other current liabilities (attach schedule)	STMT 2	378,362.		385,828.
18 Loans from shareholders				44,243.
19 Mtges., notes, bonds payable in 1 year or more		4,478,424.		3,273,237.
20 Other liabilities (attach schedule)	STMT 2	66,657.		98,857.
21 Capital stock		2,000.		2,000.
22 Paid-in or capital surplus	STMT 2	283,097.		283,097.
23 Accumulated adjustments account	-1,951,933.		-3,317,090.	
24 Other adjustments account				
25 Shareholders' undistributed taxable income previously taxed				
26 Other retained earnings (see instructions)	-2,750.		-2,750.	
Check this box if the corporation has subchapter C earnings and profits at the close of the tax year ▶ ☐ (see instructions)				
27 Total retained earnings per books–Combine amounts on lines 23 through 26, columns (a) and (c) (see instructions)		-1,954,683.		-3,319,840.
28 Less cost of treasury stock	( )	( )	( )	( )
29 Total liabilities and shareholders' equity		4,131,626.		4,206,653.

Schedule M Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (If Schedule L, column (c), amounts for lines 23, 24, or 25 are not the same as corresponding amounts on line 9 of Schedule M, attach a schedule explaining any differences. See instructions.)

	Accumulated adjustments account	Other adjustments account	Shareholders' undistributed taxable income previously taxed
1 Balance at beginning of year	-1,951,933.		
2 Ordinary income from page 1, line 21			
3 Other additions	9,954.		SEE STATEMENT 8
4 Total of lines 1, 2, and 3	-1,941,979.		
5 Distributions other than dividend distributions			
6 Loss from page 1, line 21	1,060,075.		
7 Other reductions	(309,748.		SEE STATEMENT 8
8 Add lines 5, 6, and 7	1,369,823.		
9 Balance at end of tax year - Subtract line 8 from line 4	-3,311,802.		