#S-12 signed 7-28-04

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS

In re:	
DURWIN MALL, **SHIRLEY MALL,**	**CASE NO. 04-40381-11** **CHAPTER 11**
DEBTORS.	

ORDER APPROVING DEBTORS' APPLICATION TO EMPLOY STUMBO, HANSON & HENDRICKS, LLP, AS COUNSEL

This matter is before the Court on the Debtors' application to employ counsel and the United States Trustee's objection. The Debtors appear by proposed counsel Wesley F. Smith and Todd A. Luckman of Stumbo, Hanson & Hendricks, LLP. United States Trustee Mary E. May appears by counsel William F. Schantz. The court has reviewed the relevant materials and is now ready to rule.

FACTS

The Debtors filed a Chapter 11 bankruptcy petition on February 27, 2004. In their schedules, they reported that they own fifteen pieces of real property, which they estimated to have a total value of about $690,000, and that they own about $200,000 worth of personal property. They indicated they have debts of around $806,000, about $44,000 of which are completely unsecured. Most of the real properties are rental houses, although they also include a warehouse, some farm ground, and the Debtors' homestead. On all but their homestead, the Debtors indicated the properties are subject to secured claims exceeding their fair market values, so they presumably expect that most of the secured claims will have unsecured components. One of the properties had been unencumbered until they gave Stumbo, Hanson a mortgage to secure the payment of its fees and expenses for representing them in bankruptcy.

One of the Debtors manages their rental properties, and the other is a schoolteacher. The schedules indicate the Debtors had about 18 rental units when they filed for bankruptcy (one property contained six units). At that time, five of the units were vacant and their tenants were behind on the rent in four more of them. Presumably, the vacancies and delayed rents caused the Debtors to have cash flow problems.

On the day they filed their Chapter 11 petition, the Debtors filed an application to employ Stumbo, Hanson & Hendricks, LLP, as their attorneys. The application states that the Debtors did not pay the lawyers any retainer, but instead gave the firm a promissory note for $15,000, secured by a mortgage on an otherwise unencumbered rental property ("the Mortgaged Property"). The Debtors propose that the law firm will submit to the Debtors and the United States Trustee monthly bills showing the services performed and expenses incurred, and if neither objects, the Debtors will pay 75% of the fees and 100% of the expenses, subject to later approval by the Court under the usual fee application procedure established by §§ 330 and 331 of the Bankruptcy Code[1] and Federal Rule of Bankruptcy Procedure 2016.

[1] 11 U.S.C.A. §§ 330 & 331.

The U.S. Trustee objected to the application, asserting that the mortgage gave the law firm an interest adverse to the bankruptcy estate, disqualifying its members from representing the Debtors. In response, the Debtors contend that they wanted to sell the Mortgaged Property to obtain money for a cash retainer, but had difficulties with their lenders that forced them to file for bankruptcy before they could do so. They add that the Mortgaged Property does not provide a meaningful cash flow, and is not necessary to a reorganization. The parties have now fully briefed the question whether Stumbo, Hanson is disqualified from representing the Debtors. The U.S. Trustee has not questioned any of the Debtors' factual assertions, or offered any evidence to contest them.

DISCUSSION

In a Chapter 11 bankruptcy, the debtor is ordinarily the "debtor in possession" and has most of the rights, powers, and duties given to a trustee serving in a Chapter 11 case.[2] This includes the power under § 327(a) of the Bankruptcy Code, with the Court's approval, to hire attorneys "that do not hold or represent an interest adverse to the estate, and that are disinterested persons."[3] The U.S. Trustee argues that the mortgage necessarily gave Stumbo, Hanson an interest adverse to the estate, so the firm cannot be employed by the Debtors.

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[2]*See* 11 U.S.C.A. §§ 1101(1) & 1107(a).

[3]11 U.S.C.A. § 327(a).

Claiming that the decisions in *In re Pierce*[4] and *In re Escalera*[5] imposed a *per se* rule that an attorney who has a security interest in property of the bankruptcy estate is disqualified from representing the debtor, the U.S. Trustee asks the Court to adopt a similar rule. The Court believes that *Pierce* is distinguishable from this case, and that any *per se* rule it might have suggested was dicta offered with only minimal justification. The debtors in *Pierce* owed the attorney a prepetition debt for services in connection with a state court lawsuit and gave him a mortgage that secured that debt as well as payment of his postpetition fees for bankruptcy services. The bankruptcy court ruled that the attorney was not disinterested because he was a "creditor" and held the mortgage to secure payment of prepetition and postpetition fees.[6] The Eighth Circuit affirmed this ruling. Then, the circuit went on to suggest that the bankruptcy court could also have denied the attorney's fees because the mortgage gave him an interest adverse to the estate, citing a decision by a bankruptcy court in the First Circuit, *In re Martin*,[7] for the rule that a mortgage securing postpetition legal fees creates an adverse interest, but otherwise offering no explanation why there should be a *per se* disqualification rule.[8]

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[4]53 B.R. 825 (Bankr. D. Minn. 1985), *aff'd* 809 F.2d 1356 (8th Cir. 1987).

[5]171 B.R. 107 (Bankr. E.D. Wash. 1994) (*en banc*).

[6]53 B.R. at 828.

[7]59 B.R. 140, 143 (Bankr. D. Maine 1985).

[8]809 F.2d at 1362. The Eighth Circuit also cited *In re Roberts*, 46 B.R. 815, 849 (Bankr. D. Utah 1985) for the proposition that a debt owed to an attorney for fees for prepetition, nonbankruptcy work would create an adverse interest. *Roberts* is not relevant here because the Debtors do not owe Stumbo, Hanson any debt for prepetition legal services not related to the bankruptcy filing.

Whether the circuit viewed this as a mandatory rule is unclear because it said the bankruptcy court "could . . . have denied" the fees based on the mortgage, not that it was required to deny the fees for this reason. In any event, the *Martin* bankruptcy court decision was reversed by the First Circuit a couple of months after the Eighth Circuit decided *Pierce*,[9] so the Eighth Circuit's dicta possibly suggesting a *per se* rule that having a mortgage to secure payment of fees always disqualifies an attorney from representing the debtor in a bankruptcy case was seriously undermined shortly after its opinion was issued.

Escalera involved an attorney who was not a prepetition creditor of the debtors and was given a lien solely to secure payment for postpetition services.[10] The main rationale expressed in *Escalera*, rejecting the attorney's argument that his mortgage was analogous to taking a retainer, was this:

> Arguably, if state law allows an advance fee retainer to be treated as a possessory security interest, this court would find no basis to distinguish between such a retainer and a mortgage given as security for future fees. A debtor's counsel would have a priority in the retainer to the exclusion of other administrative claimants. In [the state of] Washington, however, retainers which are given as an advance against fees are the client's funds and are to be held in trust until earned. In bankruptcy, such a retainer constitutes a trust fund held for the benefit of the estate. As estate funds, counsel may draw against them only upon court authorization, and only after notice to all the creditors with opportunity to object. Thus, holding an advance fee retainer is different from holding a lien in property of the estate. Holding the retainer in trust does not create an interest adverse to

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[9]*See* 817 F.2d 175 (1st Cir. 1987).

[10]171 B.R. at 109.

> the estate. But an attorney who holds a lien against property of the estate to secure his fees to the prejudice of those who are entitled to payment pursuant to the Code distribution scheme, also holds an interest adverse to that of the estate.[11]

This Court is rather surprised to see the assertion that cash owned by the debtor but held in an attorney's trust account is better protected from the attorney's claim for fees for postpetition services than is property owned and possessed by the debtor that is merely subject to a security interest in favor of the attorney. Like the money in the trust account, property that is subject to a security interest remains property of the estate. In either case, the attorney must seek the Court's approval of fees for postpetition services,[12] and fee applications of more than $1,000 must be noticed to all creditors.[13] The Court questions the view that an attorney holding an advance retainer would not have "a priority in the retainer to the exclusion of other administrative claimants" simply because state law would treat the money as being held in trust rather than as a possessory security interest. If holding the money would not give the attorney priority, why would the attorney be allowed to hold it in trust at all and not be required to turn it over to the bankruptcy estate for ratable distribution among all administrative claimants? In any event, Kansas law on this point is different than Washington law: an attorney can obtain a valid lien against a cash retainer for future fees by complying with certain statutory

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[11]171 B.R. at 111 (footnotes omitted).

[12]*See* Fed. R. Bankr. P. 2016(a).

[13]*See* Fed. R. Bankr. P. 2002(a)(6).

requirements, and thereby obtain priority over competing creditors and administrative claimants as the fees are earned.[14] The Court also disagrees with the implicit suggestion of this passage that an attorney with a security interest could somehow enforce the security interest against estate property without the Court's authorization or without affording creditors with notice and an opportunity to object.

Given the shortcomings of the *Pierce* and *Escalera* decisions, the Court is not inclined to adopt any *per se* rule they might impose against a Chapter 11 debtor's use of a mortgage or security interest in lieu of a cash retainer to obtain counsel. Instead, the Court believes it is more appropriate to analyze the propriety of such a mortgage or security interest on a case-by-case basis, taking into consideration all the relevant circumstances involved in each case. This is the approach suggested by the First Circuit when it reversed the bankruptcy court's decision in *In re Martin*.[15] As that circuit pointed out, a strict, literal interpretation of the disinterestedness and no-adverse-interest requirements of § 327(a) would mean that an attorney becomes disqualified as soon as he or she does any work for the debtor (except one working on an unlikely cash-only or *pro bono* basis) because that would make him or her a creditor.[16] In addition, no matter what arrangements are made, an attorney representing a Chapter 11 debtor (except one acting

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[14] *Rajala v. Hodes (In re Hodes)*, 289 B.R. 5, 16-17 (D.Kan. 2003).

[15] 817 F.2d 175, 180-83 (1st Cir. 1987) (reversing 59 B.R. 140 (Bankr. D. Me. 1986)).

[16] 817 F.2d at 180.

as a volunteer) will always have some level of personal interest in making sure he or she gets paid, so there will always be some risk that the attorney's personal interest might affect his or her advice.[17] In this Court's view, an attorney with an enforceable mortgage to secure payment of his or her allowable fees would be at least as likely to give advice unaffected by his or her personal interest in getting paid as an attorney who must rely only on the Debtors' postpetition ability to pay. That is, by increasing the likelihood of getting paid, the mortgage would be as likely to reduce the impact of the attorney's personal interest as to increase it.

The First Circuit identified a number of considerations that might influence the decision whether to approve the Debtors' hiring of Stumbo, Hanson despite the potential problems posed by the mortgage:

> This inquiry must of necessity be case specific. There must be at a minimum full and timely disclosure of the details of any given arrangement. Armed with knowledge of all of the relevant facts, the bankruptcy court must determine, case by case, whether the security interest coveted by counsel can be tolerated under the particular circumstances. In so doing the court should consider the full panoply of events and elements: the reasonableness of the arrangement and whether it was negotiated in good faith, whether the security demanded was commensurate with the predictable magnitude and value of the foreseeable services, whether it was a needed means of ensuring the engagement of competent counsel, and whether or not there are telltale signs of overreaching. The nature and extent of the conflict must be assayed, along with the likelihood that a potential conflict might turn into an actual one. An effort should be made to measure the influence the putative conflict may have in subsequent decisionmaking. Perceptions are important; how the matter likely appears to creditors and to other parties in legitimate interest should be taken into

[17] 817 F.2d at 181.

> account. There are other salient factors as well: whether the existence of the security interest threatens to hinder or to delay the effectuation of a plan, whether it is (or could be perceived as) an impediment to reorganization, and whether the fundamental fairness of the proceedings might be unduly jeopardized (either by the actuality of the arrangement or by the reasonable public perception of it).[18]

Although the U.S. Trustee recognizes that the Court might prefer this approach to a *per se* disqualification rule, she points to nothing about this specific case that suggests Stumbo, Hanson should be disqualified. Stumbo, Hanson, by contrast, points to several facts indicating that the mortgage should not be fatal: (1) the Debtors would have paid the cash retainer that the U.S. Trustee would apparently find acceptable except that they could not get the Mortgaged Property sold before their creditors' activities made their bankruptcy filing necessary; (2) the Debtors owe Stumbo, Hanson no prepetition debt for nonbankruptcy services; (3) the mortgage arrangement was disclosed in the materials filed with the Debtors' bankruptcy petition; (4) the U.S. Trustee has produced no evidence suggesting that the Debtors could have obtained competent counsel without paying any retainer or giving a mortgage or security interest; (5) the mortgaged property represents about 1.68%[19] of the value of all the Debtors' assets, and produces only a minimal cash flow; (6) most other administrative claimants could insist on some similar assurance of payment before agreeing to provide goods or services to the Debtors; and (7)

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[18]817 F.2d at 182.

[19]The law firm gives the figure as 1.33%, but the Court's own calculation results in this slightly higher percentage.

the Mortgaged Property is not essential to the Debtors' reorganization. The only evidence before the Court indicates that any attorneys the Debtors might have tried to hire would have insisted on some kind of assurance that their fees would be paid, such as a cash retainer, or a mortgage or other security interest like the one Stumbo, Hanson took here.

The Court believes that a mortgage on otherwise unencumbered real property is probably less likely than any other type of tangible, non-cash security for attorney fees to cause an actual conflict of interest to arise, because real property tends to have a more stable value than other types of non-liquid assets, significant depreciation is unlikely to occur during the course of the bankruptcy case, and significant casualty losses are less likely than with most other types of tangible property. Furthermore, while real property in general tends not to have much going-concern value, a residential rental property like the one involved here almost never has any going-concern value. These factors substantially reduce the risk that the law firm will be tempted to take steps to increase its chances of getting paid despite their potential detrimental impact on the Debtors' reorganization efforts. Besides, the mortgage here appears likely to be a temporary arrangement, lasting only until the Debtors can sell the mortgaged property; after that, the law firm will hold the proceeds in its trust account as a cash retainer, the arrangement the U.S. Trustee has indicated would not be objectionable.

The U.S. Trustee suggests that this case might have been administered more economically in Chapter 7, and so seems to be questioning Stumbo, Hanson's presumed advice that the Debtors should file a Chapter 11 bankruptcy petition, rather than a Chapter 7 one, in order to liquidate many of their assets. In light of the Debtors' estimates that all the real properties except their homestead are mortgaged for more than their value, though, a Chapter 7 trustee would probably simply abandon the properties, and the secured creditors would then dispose of them through foreclosure sales. By trying to sell the properties in Chapter 11, though, the Debtors increase the chances that the sales will produce something close to the actual market value of each property, instead of the reduced amount typically obtained through an involuntary foreclosure sale.

Considering all the circumstances presented here, the Court concludes that under the *Martin* approach, Stumbo, Hanson is not disqualified from representing the Debtors. The firm disclosed the note and mortgage arrangement, and the U.S. Trustee has not suggested that it needs additional information to evaluate the propriety of the arrangement. The arrangement appears to be reasonable, and nothing suggests that it was not negotiated in good faith. The amount secured does not seem to be excessive, and nothing about the deal suggests any overreaching; the Court notes the U.S. Trustee has expressed no concern about the size of the mortgage. Due to the Debtors' limited cash flow, the mortgage appears to have been necessary to obtain counsel and, in light of the

Debtors' plan to sell the Mortgaged Property anyway, the mortgage should not interfere with their reorganization efforts. The mortgage is simply functioning as a reasonable substitute for an immediate cash retainer. Stumbo, Hanson says it recognizes that approval of its employment will not give it permission to take the proceeds of any sale of the Mortgaged Property as its fees, but will merely authorize it to treat the proceeds as a cash retainer, with all its fees remaining subject to review and approval by the Court.

In published opinions, at least three courts have similarly concluded that a mortgage on real property or a security interest in other property, given to secure payment of a debtor's attorney's fees, was essentially the same as a cash retainer.[20] Two of those courts said that the security retainers were acceptable in the cases before them, but nevertheless declared, without explaining why, that the attorneys would have to share the benefits of the retainers with the other administrative claimants in the cases.[21] The third court disagreed with this limitation on the effect of the attorney's lien, pointing out that such a requirement effectively eliminates the purpose of the security retainer.[22] This Court agrees with the latter court, and rejects any suggestion the U.S. Trustee may

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[20]*In re Quincy Air Cargo, Inc.*, 155 B.R. 193, 197 (Bankr. C.D. Ill. 1993) (security interests in vehicles); *In re Carter*, 101 B.R. 563, 564-65 (Bankr. E.D. Wis. 1989) (McGarity, J.), *aff'd* 116 B.R. 123 (E.D. Wis. 1990) (seller's interest under land contract); *In re Shah International, Inc.*, 94 B.R. 136, 138 (Bankr. E.D. Wis. 1988) (Eisenberg, J.) (two real property mortgages).

[21]*Carter*, 101 B.R. at 564-66, *aff'd* 116 B.R. at 127; *Shah Internat'l*, 94 B.R. at 139.

[22]*Quincy Air Cargo*, 155 B.R. at 196-97.

be making that Stumbo, Hanson should be forced to share the proceeds of its mortgage with other administrative claimants.

CONCLUSION

For these reasons, the Court is convinced that the mortgage should not disqualify Stumbo, Hanson from serving as the Debtors' attorneys in this case. The Debtors' application to employ the law firm is hereby approved. Stumbo, Hanson may submit detailed monthly billing statements to the Debtors and the U.S. Trustee, and collect 75% of the fees and 100% of the expenses shown on those bills, unless the Debtors or the U.S. Trustee object within ten days of service of each bill. The firm's fees and expenses will remain subject to ultimate approval by the Court, under the usual procedures for seeking such approval. Stumbo, Hanson may enforce its mortgage only to the extent its fees and expenses are allowed by the Court.

IT IS SO ORDERED.

Dated this _____ day of July, 2004.

DALE L. SOMERS
BANKRUPTCY JUDGE

CERTIFICATE OF SERVICE

The undersigned hereby certifies that true and correct copies of the above **ORDER APPROVING DEBTORS' APPLICATION TO EMPLOY STUMBO, HANSON & HENDRICKS, LLP AS COUNSEL** were mailed via regular U.S. mail, postage prepaid, on the 28th day of July, 2004 to the following:

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