UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF KENTUCKY
London Division

IN RE:	:	
	:	
M3 ENERGY RESOURCES, LLC	:	**Chapter 11**
	:	**Case Nos. 11-60480**
Debtor	:	**Judge Joseph M. Scott**
_____	:	

ORDER REGARDING FINAL FEE APPLICATION OF DEBTOR'S COUNSEL AND MOTION FOR TURNOVER OF ESCROWED FUNDS TO CHAPTER 7 TRUSTEE

This matter is before the Court on the Application for Final Allowance of Compensation and Reimbursement of Accrued Expenses of Debtor's Counsel ("Final Fee Application") (Doc. 402). Debtor's counsel, Bunch & Brock, filed the Final Fee Application seeking $49,372.50 in fees and $1,169.18 in expenses for a total of $50,541.68. Counsel has $9,657.92 in retainer funds remaining in its IOLTA escrow account ("Escrow Fund") which it wants to apply toward payment of the Final Fee Application.

The Chapter 7 Trustee, James D. Lyons, filed an Objection to the Final Fee Application and a Motion for Turnover (Docs. 415 & 416) on the basis that the Escrow Fund is property of the bankruptcy estate.

This Court has jurisdiction of this matter pursuant to 28 U.S.C. § 1334(b) and this is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A), (E).

RELEVANT FACTS

1. On March 31, 2011 ("Petition Date"), Debtor filed a voluntary petition under chapter 11.

2. On March 31, 2011, Debtor filed Debtor's Application for Order to Retain Bunch & Brock as Counsel under General Retainer ("Motion to Employ") (Doc. 7).

3. In the Motion to Employ, Bunch & Brock disclosed that on March 29, 2011, it received a $50,000 retainer from Debtor that was deposited into "Bunch & Brock's IOLTA escrow account in contemplation of and in connection with this bankruptcy case" ("Prepetition Retainer").

(Motion to Employ ¶ 10). Bunch & Brock further disclosed that Debtor agreed to deposit an additional $50,000 into Bunch & Brock's escrow account within thirty days of the Petition Date ("Post-petition Retainer"). (Motion to Employ ¶ 10).

4. The Motion to Employ was granted by an order ("Fee Order") (Doc. 109) entered April 18, 2011. The Fee Order included authorization for Bunch & Brock to receive the Post-Petition Retainer of $50,000 within thirty days of the Petition Date.

5. By Amended Disclosure Statement of Attorney for Debtor ("Disclosure Statement") (Doc. 401), Bunch & Brock disclosed that the Prepetition Retainer of $50,000 was deposited into the Escrow Fund on March 31, 2011.

6. By an agreed order ("NAG Agreed Order") (Doc. 173) entered May 5, 2011, settling a motion for sanctions filed by Debtor against North American Gem US, Inc. ("NAG"), NAG was ordered to pay $1,650 to Bunch & Brock as attorney fees ("NAG Funds").

7. On May 23, 2011, Bunch & Brock filed an Application for Interim Allowance of Compensation and Reimbursement of Accrued Expenses of Debtor's Counsel ("Interim Fee Application") (Doc. 217) requesting fees in the amount of $63,377 and expenses in the amount of $1,174.54 for a total of $64,551.54. Debtor requested that Bunch & Brock's fees and expenses be paid from "funds currently held by Counsel in [the Escrow Fund] of $47,559.46 and from any other court ordered deposits into [the Escrow Fund]." (Interim Fee Application at ¶ 9).

8. On May 26, 2011, an additional $25,000 was deposited into the Escrow Fund as partial payment of the Post-Petition Retainer per the Fee Order. (Disclosure Statement at 1).

9. On June 13, 2011, an Order Approving Interim Compensation of Debtor's Counsel ("Interim Fee Order") (Doc. 271) was entered authorizing Bunch & Brock to withdraw $64,551.54 for fees and expenses from the Escrow Fund.

10. The NAG Funds were received by Bunch & Brock and pursuant to the NAG Agreed Order were deposited into the Escrow Fund on July 7, 2011 and July 12, 2011. The NAG Agreed Order provides that the $1,650 shall remain in the Escrow Fund pending further orders of the Court.

11. This case converted from Chapter 11 to Chapter 7 on September 22, 2011 (Doc. 390).

12. Bunch & Brock's Final Fee Application was filed on September 30, 2011, and requests final allowance of compensation and reimbursement of expenses for the period March 31, 2011 through September 22, 2011.

13. No objections have been filed against the Final Fee Application relating to the amount of fees and expenses or whether Bunch & Brock is entitled to be compensated. The objection relates solely to whether the Escrow Fund may be a source of payment if fees and expenses are awarded to Bunch & Brock.

14. The funds currently remaining in the Escrow Fund are $1,650 from the NAG Fund with the remaining $8,007.92 being from the $25,000 Post-Petition Retainer.[1]

LAW AND ANALYSIS

Pursuant to 11 U.S.C. § 541(a)(1), an estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case."[2] With respect to whether funds held as a retainer by Debtor's counsel are property of the estate, the Sixth Circuit has stated:

> We conclude that the $10,000 of interim compensation that [Debtor's counsel] was authorized to keep . . . was always subject to disgorgement. Interim compensation is subject to re-examination and adjustment. This includes retainers, which are held in trust for the estate, and *remain the property of the estate*. As discussed above, interim compensation is payment for professional services authorized by § 330(a), and § 330(a) fees are administrative claims. [Debtor's counsel's] claim, like other approved administrative claims on the estate, at all times remained subject to the statutory *pro rata* distribution scheme in § 726(b).

Specker Motor Sales Co. v. Eisen, 393 F.3d 659, 662-63 (6th Cir. 2004) (emphasis added, citations omitted). Bunch & Brock are in the same situation with respect to their Final Fee

[1]The entire Prepetition Retainer was disbursed when Bunch & Brock paid itself the amount of fees and expenses requested in the Interim Fee Application and approved by the Interim Fee Order.

[2]Conversion of Debtor's case to one under Chapter 7 did not change the Petition Date. *See* 11 U.S.C. § 348(a). Property of the estate is, therefore, determined as of the original Petition Date. *See* ALAN N. RESNICK AND HENRY J. SOMMER, *Collier on Bankruptcy*, ¶ 348.02[1] (16th ed. 2011).

Application as was debtor's counsel in *Specker Motors*. Although *Specker Motor* has been criticized, it is binding on this Court. If the Escrow Fund remains property of the estate, it must be turned over to the Trustee. However, the Bankruptcy Appellate Panel for the Sixth Circuit has found that the *Specker Motors* decision "is limited because it did not address the effect of an attorney's lien on a retainer under state law." *Cupps & Garrison, LLC v. Rhiel (In re Two Gales, Inc.)*, 454 B.R. 427, 434 (B.A.P. 6th Cir. 2011) (remanding to bankruptcy Court for determination of whether under Ohio law the attorney held a perfected lien in the retainer).

Based on *Specker Motors* and *In re Two Gales,* whether the Escrow Fund is property of the estate depends on (i) whether Bunch & Brock obtained an attorney's lien in the Escrow Fund under state law; and (ii) if Bunch & Brock did not obtain an attorney's lien, then the Court must consider the type of retainer obtained by Bunch & Brock. "[I]f [Bunch & Brock's] retainer is not of the type that is considered to be an estate asset, then this court would not have the authority to require [Bunch & Brock] to surrender a portion of it to the estate." *In re James Contracting Grp., Inc.*, 120 B.R. 868, 871 (Bankr. N.D. Ohio 1990).

Bunch & Brock also raises the argument that the Trustee is not entitled to turnover of the Escrow Funds because prior to conversion of the case to Chapter 7, certain parties agreed in open court to permit a carve out of the funds then remaining in the Escrow Fund for Bunch & Brock's fees.

A. *Attorney's Lien under Kentucky Law*. Kentucky law provides for an attorney's lien in certain situations and provides that:

> Each attorney shall have a lien upon all claims, except those of the state, put into his hands for suit or collection or upon which suit has been instituted, for the amount of any fee agreed upon by the parties or, in the absence of such agreement, for a reasonable fee. If the action is prosecuted to a recovery of money or property, the attorney shall have a lien upon the judgment recovered, legal costs excepted, for his fee. If the records show the name of the attorney, the defendant shall be deemed to have notice of the lien.

KY. REV. STAT. ANN. § 376.460 (West 2011). The lien attaches to money or property that is recovered by the attorney for his client. *Johnson v. Breckinridge*, 1883 WL 7217 (Ky. 1883); *see also Meehan v. Ruby*, No. 2009-CA-002402-MR, 2011 WL 1515415, at *3 (Ky. App. Apr. 22 2011)

("The right to file an attorney's lien is founded upon the theory that the attorney's services and skills produced the property that the client now possesses."). KRS § 376.460 does not permit a lien against property or assets that did not arise directly as a result of the underlying suit. *Meehan*, 2011 WL 1515415, at *3 (citing *Wilson v. House*, 73 Ky. 406 (Ky. 1874)). An attorney's lien created by KRS § 376.460 is a choate lien when the following are established: (i) the identity of the lienor, (ii) the property subject to the lien, and (iii) the amount of the lien. *United States v. Bates*, 158 F. Supp. 32, 33 (E.D. Ky. 1957) (citing *United States v. City of New Britain*, 347 U.S. 81, 84, 74 S. Ct. 367, 369, 98 L. Ed. 520 (1954)).

In its argument, Bunch & Brock substitutes in the first sentence of KRS § 376.460, the word "retainer" for "claims" which misstates the law. (Debtor's Objection at 6). The word "claims" as used in the statute refers to the cause of action placed in the attorney's hands, not to any funds placed in the attorney's hands by the client at the beginning of a case. *See Meehan* 2011 WL 1515415, at 3 ("The right to file an attorney's lien is founded upon the theory that the *attorney's services and skills produced the property* that the client now possesses.") (emphasis added). A retainer is given at the beginning of a case, not after the attorney has had successful results. Bunch & Brock's services and skills did not produce the funds used by the Debtor to pay the Post-Petition Retainer. Bunch & Brock did not obtain an attorney's lien in the funds representing the Post-Petition Retainer.

Bunch & Brock did, however, obtain an attorney's lien in the NAG Fund because those funds were awarded specifically to Bunch & Brock as attorney fees related to the filing of the motion for sanctions against NAG. As a result of the NAG Agreed Order which was negotiated by Bunch & Brock on its behalf in an underlying contested matter with NAG, the Debtor was granted access to property which had been denied by NAG and Debtor was also granted attorney fees which are part of the funds being held in the Escrow Fund. Thus, the $1,650 is the property and the amount of the lien granted to Bunch & Brock. Based on terms of the NAG Agreed Order and the attorney's lien in the NAG Fund, the NAG Fund is not property of the bankruptcy estate.

B. *Agreement of Parties Permitting Carve Out for Bunch & Brock's Fees.* Bunch & Brock asserts that it is entitled to apply the Escrow Fund to its Final Fee Application because of the parties' agreement in open court permitting a carve out for Bunch & Brock's fees of the amount remaining in the Escrow Fund?

At a hearing on July 21, 2011, the parties entered into an agreement on the record regarding deadlines for the Debtor to enter into a letter of intent and asset purchase agreement, along with other agreements and deadlines ("Oral Agreement").[3] Bunch & Brock states that part of that agreement, as read into the record by Ken Gish, counsel for certain creditors referred to in this case as the Aspen Parties, provided that:

> The first detail of the proposed agreed order will be that the administrative claims sought in the motion before the Court today will be allowed, but not yet paid, and *the terms of the agreed order will include a carve out for Mr. Bunch's fees that remain in his escrow*.

(Debtor's Objection, Trans. of Hearing held July 21, 2011, Ex. 1 at 4:16-21 (emphasis added)). Bunch & Brock then argues that the general rule is that a subsequent chapter 7 trustee is bound by prior actions of the debtor-in-possession or in other words that the Oral Agreement is binding on Mr. Lyons as the subsequent chapter 7 trustee in this case. In support of its argument, Bunch & Brock cites *Terlecky v. Peoples Bank, N.A. (In re Amerigraph, LLC)*, 456 B.R. 349 (Bankr. S.D. Ohio 2011). The *Amerigraph* case does support Bunch & Brock to a certain extent, but the policy behind making the prior actions of the debtor-in-possession binding the chapter 7 trustee does not apply in this situation. The court in *Amerigraph* stated:

> It is, . . . , well established that a Chapter 7 trustee succeeds to the rights of the debtor-in-possession and is bound by prior actions of the debtor-in-possession to the extent approved by the court. Thus, an agreement made by a debtor-in-possession that is set forth in an agreed cash collateral order generally will—unless the order expressly states otherwise—be binding on a Chapter 7 Trustee. *The general rule serves the salutary purpose of encouraging creditors to deal freely with debtors-in-possession, within the confines of the bankruptcy laws, without fear of reversal at the hands of a later appointed trustee*. Put differently, the general rule will encourage lien creditors to better cooperate with a reorganizing debtor and reduce pressure, early in the case, to litigate and, perhaps, prematurely 'pull the plug' on a debtor.

[3] The Oral Agreement between the parties was never reduced to writing but the Court found at a subsequent hearing held on August 3, 2011, that the Oral Agreement was, nevertheless, binding on the parties. (Debtor's Objection, Trans. of Hearing held August 3, 2011, Ex. 2 at 4:10-12).

> The general rule applies whether or not the order containing the debtor-in-possession's agreement expressly makes the order binding on a trustee—*at least where, as in the instant case, the agreed order expressly states that its provisions will survive conversion to Chapter 7*. The Court, therefore, rejects the Trustee's argument that the Cash Collateral Order is not binding on him merely because it did not expressly state that it would be binding on a Chapter 7 Trustee.
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> The general rule, however, is applicable only if proper notice of the debtor-in-possession's agreement is provided to parties in interest. Accordingly, those courts that have applied the rule have done so only after making it clear that adequate notice has been provided.

Amerigraph, 456 B.R. at 356-57 (internal quotations and citations omitted) (emphasis added). This case before the Court can be distinguished from the *Amerigraph* case because (i) the parties' Oral Agreement was never reduced to an agreed order—although the Court has recognized that the Oral Agreement is binding on the parties; (ii) there was never any statement put into the record that the Oral Agreement survived conversion of the *M3 Energy* Chapter 11 case to a Chapter 7; and (iii) M3 Energy is the party attempting to enforce the Oral Agreement which is contrary to the "purpose of encouraging creditors to deal freely with debtors-in-possession."

Finally, for the Chapter 7 Trustee to be bound by the Oral Agreement, all interested parties must have had notice of the Oral Agreement. Bunch & Brock argues that "[p]roper notice of the July 21st hearing was provided and all parties appearing were aware of the agreement read into the Record." (Debtor's Objection at 6). However, since the Oral Agreement was never reduced to an Agreed Order, the terms of the Oral Agreement, including the carve out for Bunch & Brock, were never provided to the unsecured creditors. A representative of the U.S. Trustee's Office was not present at the hearing. As the Court noted at the July 21, 2011 hearing:

> THE COURT: Counselors, am I to anticipate one sweeping agreement that will have all of this in it, my concerns are several. The first is, there isn't anybody in the courtroom that has anything to say about the unsecured creditors, and there's about to be a big puff of smoke and maybe no case, or maybe a case, so I'm interested in knowing what sort of notice is going to be given, to whom, where the Natural Resources Cabinet fits in. There is a creditor's committee that has been appointed. As far as I know it does not have counsel. . . .
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> . . .
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> THE COURT: [With respect to the proposed agreed order] I will be interested in some certificate of service such that it has been served on all parties including

> the committee – including specifically the committee members and the US Trustees. Has the US Trustee's office had any involvement in any of the matters that have come up today?
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> MR. GISH: No, Your Honor.
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> MR. BUNCH: No, Your Honor.
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> THE COURT: I suspect they will end up being the representative for the unsecured creditors.

(Debtor's Objection, Trans. of Hearing held July 21, 2011, Ex. 1 at 11:3-18; 12:22-13:6). Because the unsecured creditors did not receive notice of the Oral Agreement which would have been through service of a written agreed order, all interested parties did not receive notice, and the Oral Agreement providing for a carve out for Bunch & Brock's fees is not binding on the subsequently appointed Chapter 7 Trustee in this case.

C. *Bunch & Brock's Retainer is a Security Retainer*.

> There are basically two general categories of retainers: a classic retainer and a special retainer. Under the classic retainer, a client agrees to pay a fixed sum in exchange for the attorney's promise to perform legal services that may arise during a specific period of time. It is earned by the attorney upon payment. The special retainer is divided into two further categories, a security retainer and an advanced fee retainer. The security retainer allows the attorney to hold the retainer to secure payment of fees for future services. The funds remain the property of the debtor until applied by the attorney for services rendered. The advanced fee retainer is similar to the security retainer except that the ownership in the funds passes at the time of the payment of the funds to the attorney.

In re USHC, LLC, 456 B.R. 304, 307 (Bankr. W.D. Ky. 2011) (citations omitted). A security retainer has been further described as:

> [T]he typical retainer encountered in Chapter 11 cases. The debtor maintains an interest in the retainer until the funds are applied to charges for services actually rendered. Thus, until they are applied for services actually rendered, the funds in a security retainer remain an asset of the estate. As such, they are subject to the fee application process under 11 U.S.C. § 330.

In re James Contracting Grp., 120 B.R. at 871 (citations omitted). Thus, where an attorney obtains either a classic retainer or an advanced fee retainer—which are not the typical retainers approved in the Chapter 11 context—ownership of the funds passes to the attorney at the time of delivery. However, funds held in a security retainer are property of the estate until they are applied for services actually rendered.

A copy of the fee agreement between the Debtor and Bunch & Brock is not part of the record before the Court and is, therefore, unavailable to assist us in determining the type of retainer held by Bunch & Brock. The reference to the retainer in the Motion to Employ refers to a "general retainer." However, from a review of the fee applications (Docs. 217 & 402) in this case, it is evident that Bunch & Brock and this Court treated the retainer as a security retainer that could not be applied until the services were actually rendered and approved by the Court. The Interim Fee Application and Final Fee Application both request that Bunch & Brock be authorized to draw down on the Escrow Fund for payment of the requested fees and expenses. (Fee Applications ¶ 9). Further, the Fee Order granting the motion for interim compensation specifically authorized and ordered Debtor and Bunch & Brock to pay the allowance of $64,551.54 to Bunch & Brock from the Escrow Fund.

Therefore, the Court finds that the Post-Petition Retainer remaining in the Escrow Fund in the amount of $8,007.92 is a security retainer that remains property of the bankruptcy estate until Court approval is obtained to apply those funds to the payment of services actually rendered.

Based on the findings set forth above,

IT IS, HEREBY, ORDERED that:

1. The Final Fee Application is **SUSTAINED** to the extent that Bunch & Brock is awarded attorney fees in the amount of $49,372.50 and expenses in the amount of $1,169.18 for a total of $50,541.68.

2. The Trustee's Objection to the Final Fee Application and Motion for Turnover is **OVERRULED** as to the portion of the Escrow Fund representing the NAG Fund in the amount of $1,650 and Bunch & Brock is permitted to apply the $1,650 toward payment of its attorney fees and expenses.

3. The Trustee's Objection to the Final Fee Application and Motion for Turnover is **SUSTAINED** as to the portion of the Escrow Fund representing the Post-Petition Retainer in the amount of $8,007.92 and Bunch & Brock is hereby **ORDERED** to immediately turn over those funds to the Trustee.

Copies to:
James D. Lyon, Esq. **(for service on all interested parties)**
Matthew B. Bunch, Esq.
Rachelle C. Dodson, Esq., for U.S. Trustee

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The affixing of this Court's electronic seal below is proof this document has been signed by the Judge and electronically entered by the Clerk in the official record of this case.

Signed By:
Joseph M. Scott, Jr.
Bankruptcy Judge
Dated: Wednesday, November 30, 2011 (jms)
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