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Order Affirming Ruling Of Bankruptcy Court; Denying Appellee's Motion For Sanctions; Denying Appellant's Cross Motion For Sanction

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA

DEUTSCHE FINANCIAL SERVICES, Plaintiff, No.C98-21225 JW v.

ORDER AFFIRMING RULING OF BANKRUPTCY COURT; DENYING APPELLEE'S MOTION FOR SANCTIONS; DENYING APPELLANT'S CROSS MOTION FOR SANCTIONS

INVERSE CORPORATION, Defendant. _____/

I. INTRODUCTION

Presently before the Court is Appellant Deutsche Financial Services ("Appellant") appeal of an order of the United States Bankruptcy Court in the underlying bankruptcy proceeding on October 27, 1998, which granted Appellee/Debtor Inverse Corporation's ("Appellee") Application To Employ Counsel On Contingency Fee Basis And Authorizing Lien Against Proceeds ("Order"). The matter was heard on March 1, 1999. Based upon all pleadings filed to date, the Court affirms the order of the Bankruptcy Court.

II. BACKGROUND

The underlying bankruptcy case was commenced on September 12, 1997 when Appellee filed a voluntary petition under chapter 11. Appellee's assets included \$2,741,204 of claims for the recovery of preferential transfers against various persons and entities.

At the time that Appellee commenced the bankruptcy case, Appellant was Appellee's senior secured creditor. Appellant filed a Proof of Claim against Appellee for Four Million Five Hundred Eighty-Seven Thousand Four Hundred Eighty-Nine and 05/100 Dollars (\$4,587,489.05).

The Bankruptcy Court ordered that Binder & Malter be appointed under 11 U.S.C. §327(a) as counsel for Appellee for all legal services during the pendency of its Chapter 11 bankruptcy proceeding.

In July of 1998, Appellee filed an Application to obtain approval of its employment of counsel to pursue certain preference actions under contingency fee agreements, and to obtain the Bankruptcy Court's recognition of and authorization for attorney liens against the litigation proceeds.

In October of 1998, the Bankruptcy Court held its hearing on the Application. The Court requested and obtained from Appellee and counsel for the Official Unsecured Creditors' Committee offers of proof regarding the unwillingness of their firms and others to proceed without assurance of payment in the face appellant's claim. The Court concluded that "it's reasonable to assume that no attorney would undertake this litigation without assurance of being paid from some source." Transcript at 9:8-10:8. On October 28, 1998, the Bankruptcy Court granted Appellee's Application To Employ Counsel For Debtor To Pursue Preference Actions On Contingency Fee Basis and Authorizing Lien Against Proceeds ("Order"). The Order provides in pertinent part:

1. Debtor's employment of Binder & Malter on a contingent fee basis to prosecute adversary proceeding numbers 98-5226 ASW and 98-5232 ASW (the "Actions") be and hereby is approved on the terms of the fee agreements attached as Exhibits "A" and "B" to the Application, except that Binder & Malter's contingency shall be 25% in all circumstances;
2. Binder & Malter has a lien on any proceeds recovered in the Actions, and the attachment of said liens to the proceeds of the Actions is hereby authorized.

Appellant does not dispute the power of the Bankruptcy Court to approve the employment of counsel on a contingent fee basis. However, Appellant contends that there is no statutory nor case authority to support the Bankruptcy Court's decision to authorize an attorney lien against the proceeds of the adversary actions. Furthermore, Appellant contends that the effect of this Order is to alter the priority of unsecured creditors in violation of the "Absolute Priority Rule." More specifically, Appellant contends that the Order unfairly allows Binder & Malter a legally recognized lien that attaches automatically to the proceeds recovered in preference actions it pursues, without regard to the rights of other creditors such as Appellant. Appellant asserts that Binder & Malter's claim to any recovery on preference actions should have been classified as an unsecured administrative expense, which is not entitled to priority over Appellant's claim.

As this appeal is pending, the underlying Chapter 11 bankruptcy matter is proceeding. Binder & Malter is pursuing adversary proceeding numbers 98-5226 ASW and 98-5232 ASW. In adversary proceeding number 98-5226 ASW, Appellee seeks recovery of \$331,774.44 for the estate. In adversary proceeding number 98-5232 ASW, Appellee seeks recovery of \$609,450.66 for the estate.

III. DISCUSSION

This Court has jurisdiction over this appeal pursuant to 28 U.S.C. §158(a). In reviewing an order of the United States Bankruptcy Court, findings of fact shall not be set aside unless clearly erroneous, and "due regard shall be given to the opportunity of the bankruptcy court to judge the credibility of the witnesses." Bankruptcy Rules 8013. A finding of fact is not clearly erroneous unless the reviewing court is firmly convinced that a mistake has been committed. *In re Roberts Farms Inc.*, 980 F.2d 1248 (9th Cir. 1992). Legal conclusions by the Bankruptcy Court are reviewed *de novo*. *Id.* Equitable determinations by the Bankruptcy Court are subject to review under the abuse of

discretion standard. In re General Development Corporation, 84 F.3d 1364, 1367 (11th Cir. 1996); In re Christian Life Center, 821 F.2d 1370, 1376 (9th Cir. 1987).

In an abundance of caution, this Court has conducted a de novo review of the Bankruptcy Court's decision to authorize attachment of attorney liens to recoveries in the adversary proceedings.

Based upon the Court's review, the Court finds that the Bankruptcy Court's decision is well reasoned and supported by the law. Recognizing the lack of bankruptcy cases directly on point, the Bankruptcy Court considered whether the contingency fee agreement created a lien under California law. The Bankruptcy Court concluded that it did (see e.g. Matter of Pacific Far East Line, Inc., 654 F.2d 664 (9th Cir. 1981)), subject to the bankruptcy Court's power to affirm or avoid it under 11 U.S.C. section 549(a). The Bankruptcy Court exercised its sound discretion in authorizing the lien and its attachment. The practical effect of the Bankruptcy Court's order is that the first 25% of any recovery, plus costs, will be given to Appellee's counsel, and the balance will be available for Appellant. This result is dictated simply by operation of the law regarding contingent fee agreements and liens, and not through any priority granted by the Bankruptcy Court.

The Bankruptcy Court relied upon analogous authority under 11 U.S.C. section 364 in determining whether to allow the attorney lien and its attachment. Section 364 authorizes "priming," i.e. altering the priority of various creditors. More specifically, section 364 authorizes the trustee, if it is unable to obtain unsecured credit allowable under section 503(b)(1), to preserve the estate, to authorize the obtaining of credit or incurring of debt "(1) with priority over any and all administrative expenses of the kind specified in section 503(b) or 507(b) of this title; [and] (2) secured by a lien on property of the estate that is not otherwise subject to a lien." 11 U.S.C. ??364(c)(1), (c)(2). The Bankruptcy Court reasoned as follows:

Note that Section 364 permits a debtor to incur credit secured by property that isn't already encumbered, which is the equivalent of what's going on here. Having the attorney work on a contingency constitutes incurring credit in the form of a new debt for that attorney.

Giving the attorney a lien on proceeds of the action he works on is securing the credit with property that's not already encumbered, that is, the proceeds of the actions.

Appellant contends that the Bankruptcy Court cannot rely upon section 364 because the debtor didn't make the necessary showing under that section, i.e., that the debtor can't obtain unsecured credit by promising a regular administrative expense claim, or by analogy, that the debtor can't obtain counsel to prosecute the adversary proceedings absent an attorney lien. However, the Bankruptcy Court's discussion of section 364 was part of its reasoning and not part of the Order. Therefore, the Bankruptcy Court was not required to follow the procedural requirements of section 364. Moreover, the Bankruptcy Court requested and obtained from Appellee and counsel for the Official Unsecured Creditors' Committee offers of proof regarding the unwillingness of their firms and others to proceed with the adversary proceedings without a lien in light of Appellant's claim. The Bankruptcy Court therefore made a finding that "it's reasonable to assume that no attorney would undertake this litigation without assurance of being paid from some source." Transcript at pp. 9-10. This finding of fact is not clearly erroneous, and will not be disturbed by the Court on appeal.

Appellant contends that allowing the lien to attach results in unfairness to the Appellant because of the "Absolute Priority Rule," which provides that a senior class must be compensated in full before any class junior in claim or interest to such senior class may receive or retain anything of value under a plan. This judicially created rule evolved from Bankruptcy Code section 1129(b)(2), which requires the "fair and equitable" treatment of creditors under a Chapter 11 plan of reorganization if the reorganization is being confirmed or "crammed down" over the objection of certain creditors.

However, because the bankruptcy proceeding has not yet been confirmed, it is premature to consider whether the Bankruptcy Court has complied with section 1129(b)(2).

IV. CONCLUSION

For the reasons set forth above, the Court affirms the ruling of the Bankruptcy Court. Further, the Court finds that although Appellant was remiss in failing to comply with the Bankruptcy Rules, the drastic sanctions requested by Appellee are not warranted. Accordingly, Appellee's motion for sanctions is DENIED. Similarly, Appellant's cross-motion for sanctions is DENIED.

Dated: March 1, 1999 _____ JAMES WARE UNITED STATES DISTRICT

Decision Date:

Friday, April 30, 1999

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