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Aftermath of *Baker Botts* and Other Notable Ethics Issues

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Aftermath of *Baker Botts v. ASARCO*

Baker Botts v. ASARCO *doesn't prohibit retention agreements allowing fees for defense of fees, judge holds.*

Retention Agreements Allowing Defense Fees Ok in New Mexico, but Not in Delaware

A company planning a contentious reorganization should consider filing chapter 11 in Albuquerque, N.M., because a judge there will permit retention agreements allowing compensation for successful defense of professionals' fee applications.

An oil field contractor with about $5.5 million in assets and liabilities filed a chapter 11 petition and sought authority to retain counsel under an engagement agreement that included compensation for successful defense of the attorneys' fee applications. The U.S. Trustee and the creditors' committee objected to the fee-defense provision, citing *Baker Botts LLP v. Asarco LLC*, 135 S. Ct. 2158, 192 L. Ed. 2d 208, 83 U.S.L.W. 4428 (2015), and *In re Boomerang Tube Inc.*, 548 B.R. 69 (Bankr. D. Del. 2016).

In his Sept. 20 opinion, Bankruptcy Judge David T. Thuma analyzed whether *ASARCO*, which disallowed defense fees under Section 330(a)(1), also precludes the inclusion of a fee-defense provision in a retention agreement under Section 328(a). He concluded, "*ASARCO* does not hold that a fee defense provision can never be a 'reasonable term' under Section 328(a)."

ASARCO involved a case where the bankruptcy court awarded debtor's counsel $5.2 million for successfully defending its fees. The lawyers' retention was under Section 327, and the allowance of fees was governed entirely by Section 330, because the attorneys had no agreement with the debtor for payment of defense fees that might bring the case under the umbrella of Section 328.

Judge Thuma parsed *ASARCO*, a 6/3 decision, and found that Justice Clarence Thomas disallowed defense fees because the "services" benefitted only the lawyers, not the estate.

Next, Judge Thuma analyzed *Boomerang*, where Delaware Bankruptcy Judge Mary F. Walrath refused to approve a retention application requiring the debtor to compensate committee professionals for successfully defending their fees. She barred the use of Section 328 as a vehicle for paying defense costs because it, like Section 330(a), was not a "specific and explicit statute" overriding the American Rule against fee-shifting. Section 328 permits the court to approve retentions "on any reasonable terms and conditions of employment."

The *Boomerang* committee contended that the engagement agreement fell under the so-called contract exception to the American Rule, allowing parties by contract to agree that the losing side

pays everyone's lawyers. The argument was flawed, Judge Walrath said, because the debtor was not a party to the retention agreement. Even if the contract exception applied, Judge Walrath said she could not approve it because fee-defense costs would not entail any services for the committee, only benefit the lawyers themselves.

Judge Thuma disagreed with *Boomerang*. If the terms of employment have been approved by the court under Section 328(a), he said that the "professional's compensation is governed by those terms and conditions, rather than the general [reasonable compensation] language of Section 330(a)(1)(A)."

Judge Thuma noted that *ASARCO* did not involve a fee-defense provision in a retention agreement approved under Section 328(a). He then analyzed whether defense costs can be a "reasonable" term of employment.

Reasonable employment terms are not only those that benefit the client. Retention agreements, he said, will contain many provisions that benefit the lawyers as well. Even provisions that benefit lawyers also provide indirect benefit for the client because "the client obtains the services of needed, able professionals," Judge Thuma said.

Pre-*ASARCO*, Judge Thuma said that the experience in his district in paying successful defense costs had "been good for the most part," because "objections to fee applications have been limited to *bona fide* disputes, and the fee defense costs have been reasonable."

Unless *ASARCO* requires it, Judge Thuma said there "is no need to change the system," which "has worked pretty well." He did not read *ASARCO* "as mandating a change, if a properly drafted employment term is timely presented to the court and approved under Section 328(a)."

Judge Thuma ended his opinion by laying down criteria under which he would approve defense costs. Among other things, the debtor must approve them, committee counsel must be similarly protected, and fees will not be allowed for an unsuccessful defense.

The opinion is *In re Hungry Horse LLC*, 16-11222 (Bankr. D.N.M. Sept. 20, 2017).

Court shows antipathy to all theories seeking allowance of fees incurred in collecting fees.

ASARCO Read to Bar Fee-Defense Costs Even with a Fee-Shifting Agreement

In the wake of the Supreme Court's *ASARCO* opinion, a retained professional has virtually no chance of enforcing even a court-approved fee-shifting agreement, assuming that a decision from a district judge in Austin, Texas, was correct in upholding the denial of fees incurred in collecting fees.

The bankruptcy court approved a chapter 11 debtor's retention of an investment banker. The engagement agreement included a success fee and provided that if the success fee "is not fully paid when due," the debtor agreed "to pay all costs of collection . . . including but not limited to attorney's fees and expenses . . . ."

The debtor argued that the debt-for-equity conversion in the plan did not entitle the banker to a success fee. After the plan's effective date, the bankruptcy court disagreed and allowed the banker a $595,000 success fee. The debtor appealed but lost in both the district court and the Fifth Circuit.

After the bankruptcy court allowed the success fee, the banker moved in bankruptcy court under the fee-shifting agreement for payment of almost $200,000 in counsel fees incurred in establishing the right to collect the success fee. Bankruptcy Judge Craig A. Gargotta denied reimbursement of counsel fees.

Even though the fee-shifting agreement seemed on its face to entitle the banker to the recovery of counsel fees incurred in establishing a right to the success fee, District Judge Lee Yeakel wrote an opinion on Oct. 10 upholding Judge Gargotta on several independent grounds.

Although the bankruptcy court approved retention of the banker, Judge Yeakel ruled that the bankruptcy court must also approve attorneys hired by a court-approved professional. Since the banker's attorneys were not themselves retained with court approval, Judge Yeakel said that the banker's "claims for reimbursement of its attorney's fees and costs were properly denied."

Judge Yeakel also broadly interpreted *Baker Botts LLP v. Asarco LLC*, 135 S. Ct. 2158, 192 L. Ed. 2d 208, 83 U.S.L.W. 4428 (2015), which he construed as holding that a bankrupt estate is not responsible for a professional's time "spent litigating a fee application against the debtor in possession."

The banker argued that *ASARCO* did not apply because there was a "prevailing-party fee-shifting provision."

Judge Yeakel disagreed. The bankruptcy court properly denied reimbursement because the banker's attorney's fees and costs, "like those in *ASARCO*, were not incurred for labor performed for, or in service to," the debtor.

The result is not far removed from *In re Boomerang Tube Inc.*, 548 B.R. 69 (Bankr. D. Del. 2016), where Delaware Bankruptcy Judge Mary F. Walrath refused to approve a retention application requiring the debtor to compensate committee professionals for successfully defending their fees. In that respect, keep in mind that the bankruptcy court in the case at bar had approved fee-defense costs two years before the Supreme Court decided *ASARCO*. It is therefore questionable whether the bankruptcy court would have approved a fee-shifting agreement if *ASARCO* had already been on the books.

Judge Yeakel's decision may presage an attitude in the courts that fee-defense costs in bankruptcy will rarely if ever be reimbursed, even with a fee-shifting agreement.

The confirmed chapter 11 plan also precluded payment of the attorney's fees, according to Judge Yeakel. He focused on language in the fee-shifting agreement calling for reimbursement of the success fee were it "not fully paid when due."

The plan provided that claims would be paid on entry of a "final order," which was defined as an order no longer subject to appeal. Since the debtor promptly paid the success fee after it was upheld in the Fifth Circuit, there was no delay in payment and thus no right to recovery of attorney's fees.

The plan also included a bar date, four months after the effective date of the plan, for the filing of claims for administrative expenses. Since the bankruptcy court did not allow the claim for the success fee until after the bar date, the banker's claim for attorney's fees was untimely, Judge Yeakel said, because there were "no provisions in the plan requiring [the debtor] to pay administrative expenses that occur after the bar date."

The opinion is *Roth Capital Partners LLC v. Valence Technology Inc. (In re Valence Technology Inc.)*, 14-0949 (W.D. Tex. Oct. 10, 2017).

'Prevailing party' clauses may never be enforceable with respect to defense of fees.

Baker Botts Overrides Contractual Provision Allowing Recovery of Fee-Defense Costs

The court will likely never enforce a "prevailing party" clause in a retention agreement when it comes to the defense of fee applications, following the logic employed by Bankruptcy Judge Eddward P. Ballinger, Jr. of Phoenix.

Judge Ballinger disallowed a real estate agent's defense-of-fee expenses, even though the court-approved retention agreement allowed the recovery of attorneys' fees if the agent were the prevailing party.

A real estate firm was hired to sell property in return for a 4% commission. The engagement agreement between the debtor and the agent contained a prevailing-party provision entitling the winner to recover its costs and reasonable attorneys' fees "in any legal action."

The prevailing-party provision was not mentioned in the retention application. The court's order approving retention authorized the 4% commission but did not mention or approve the cost-shifting provision.

After selling the property, the chapter 11 debtor objected to allowance of the full commission. When the court denied the objection, the agent sought recovery of its counsel's fees under the prevailing-party clause.

In his July 28 opinion, Judge Ballinger refused to allow the recovery of attorneys' fees on the authority of *Baker Botts LLP v. Asarco LLC*, 135 S. Ct. 2158, 192 L. Ed. 2d 208, 83 U.S.L.W. 4428 (2015), where the Supreme Court held that retained counsel cannot obtain compensation for successfully defending a fee application.

Post-*Baker Botts*, Judge Ballinger said the courts are not uniform in deciding cases similar to the one before him, but he approvingly cited *In re Boomerang Tube Inc.*, 548 B.R. 69 (Bankr. D. Del. Jan. 29, 2016), where Delaware Bankruptcy Judge Mary F. Walrath categorically barred lawyers from circumventing *Baker Botts*. Judge Walrath refused to approve a retention application requiring the debtor to compensate committee professionals for successfully defending their fees.

In part, Judge Ballinger denied the recovery of defense fees because the prevailing-party provision was not mentioned in the retention application, nor was it approved in the order. However, it appears that Judge Ballinger based his decision on more than shortcomings in the retention papers.

Harking back to the rationale in *Baker Botts*, Judge Ballinger said that the "defense fees were not actual or necessary to the work for which [the agent] was specifically employed." He went on to say that the "defense fees in no way benefitted the estate."

The problematic but most significant aspect of Judge Ballinger's opinion deals with his treatment of the proviso in *Baker Botts* where the Supreme Court recognized "that contractual fee provisions may provide an exception to the American Rule," which requires each party to bear its own counsel fees, win or lose.

Judge Ballinger said, "[I]t is difficult to see a situation in which such a prevailing party provision could be upheld at least with respect to attorneys' fees incurred defending a professional's compensation. At a minimum, such a provision would need to be brought to the Court's attention during consideration" of the retention application.

Although the decision leaves the door open to the possibility of approving retentions with fee-shifting, Judge Ballinger's reference to lack of benefit for the estate suggests that costs for the defense of fees will never be compensable.

The logic of the opinion implies that the result would be the same for other retained professionals, such as accountants and investment advisors, who typically have broad indemnification provisions in their engagement agreements.

In an attack on a professional's indemnification clause, the result may turn on the nature of the dispute. In an unsuccessful attack only on the professional's fees, the *Baker Botts* rule will likely apply to cut off reimbursement, provisions of the contract notwithstanding.

On the other hand, if the professional were to defeat an attack alleging misfeasance or malfeasance in the performance of services, the general right to indemnification or reimbursement for defense costs might survive, assuming there were demonstrable benefit to the estate.

In a malpractice suit against a professional, a prevailing-party clause could be enforceable if the attack were defeated. However, an attack challenging the quality of services is most likely to arise in a proceeding challenging a fee application.

Is there a significant difference between an outright claim of malpractice and an objection that the services were substandard and fees should be reduced? Drawing a bright line to decide when prevailing-party clauses are enforceable or not seems elusive.

Eventually, *Baker Botts* may cast a shadow over blanket indemnifications and limitations of liability that are typical in the retentions of some professionals. For now, *Baker Botts* is being read broadly to bar professionals from using any theory to obtain compensation for defense of fees.

The opinion is *In re Capitol Litho Printing Corp.*, 14-13840 (Bankr. D. Ariz. July 28, 2017).

Florida judge allows fees for supplementing application with more detail.

Baker Botts Read Narrowly on Compensation for Defending Fee Application

A bankruptcy court in Florida narrowly interpreted *Baker Botts v. ASARCO* by allowing compensation for supplying more detail after an objection to a fee application that was initially in compliance with local rules.

In chapter 7, the trustee's counsel recovered $6.5 million in settlement of a fraudulent transfer suit. In compensation for the litigation and general services to the trustee, the lawyer filed a fee application for about $750,000.

In his opinion on Oct. 26, Chief Bankruptcy Judge Michael G. Williamson in Tampa, Fla., said that the fee application, as originally filed, complied with the local rules for chapter 7 cases. Nonetheless, the U.S. Trustee objected to the application, asking for additional detail akin to that which would be required under local rules were the case in chapter 11.

The lawyer decided to comply with the U.S. Trustee's request. Once additional information was provided, the U.S. Trustee in substance withdrew the objection, and the fee application was allowed in full.

On a second fee application, the lawyer sought almost $34,000 for preparation of the first fee application, including some $27,500 spent in responding to the U.S. Trustee's request for more information.

The U.S. Trustee objected to allowance of the $27,500, contending the money spent in defense of the fee application did not benefit the estate, and thus was not allowable under the Supreme Court's 2015 decision in *Baker Botts*.

Judge Williamson disagreed and allowed the entire $34,000 for fee application preparation, latching onto an analogy that Justice Thomas included in his *Baker Botts* opinion.

Justice Thomas said that preparation of an itemized bill by an auto mechanic would be "part of his 'services' to the customer." Therefore, Judge Williamson said, the "touchstone" is not whether the services were performed before or after objection.

Judge Williamson said that supplying additional information "was akin to the mechanic's preparation of an itemized bill as part of his 'services' to the customer." Here, he said, "the parties were not fighting over the amount of the bill but whether it was detailed enough."

The result might have been different, Judge Williamson said, had the U.S. Trustee's objection complained about duplication of services.

It is not entirely clear from the opinion, but services for providing additional detail might also have been allowed were the case in chapter 11. Because incurring the expense after an objection is not pivotal, response to an objection requesting more detail might also be allowable in chapter 11, since providing detail would be compensable where the expense is incurred in the initial preparation of the application.

Judge Williamson in substance wanted a rule of law that would not prompt counsel to overdo their fee applications routinely, since providing detail is compensable.

The opinion is *In re Stanton*, 11-22675 (Bankr. M.D. Fla. Oct. 26, 2016).

***Indenture trustee's fees to defend fees are compensable despite* Baker Botts.**

Indenture Trustee's Counsel Fees Are Measured by a Different Standard

An indenture trustee's counsel are entitled to fees for representing the trustee on an official unsecured creditor's committee, even though the committee has its own counsel, according to Bankruptcy Judge Kevin Gross of Delaware.

Judge Gross decided in his March 8 opinion that the indenture trustee's counsel fees were "prudent" based on the facts as they seemed at the time, without the benefit of hindsight. He also held that the indenture trustee's counsel were entitled to recover fees incurred in defending their fees, despite the Supreme Court's holding in *Baker Botts LLP v. ASARCO LLC*, 135 S. Ct. 2158 (2015).

Judge Gross wrote his opinion in the wake of the mammoth liquidation of Nortel Networks Inc., which entailed parallel proceedings in Canada, the U.S., the U.K. and elsewhere. The bankruptcy began in 2009 but did not conclude in the U.S. until January 2017, with confirmation of a chapter 11 plan based on a global settlement to distribute $7.3 billion in liquidation proceeds.

The indenture trustee for holders of about $150 million in senior guaranteed notes was a member of the unsecured creditors' committee and a so-called Core Party in the allocation dispute.

Two holders with 90% of the notes objected to the payment of $4.4 million of the $8.1 million in fees requested by the indenture trustee and its counsel. The indenture trustee's fees would be paid largely from the distribution that the noteholders are to receive.

The standards for calculating the indenture trustee's counsel fees were somewhat different from the rules for retained professionals in chapter 11 cases. The general standard, a product of the indenture and New York law, calls for the indenture trustee to exercise the "care and skill" that a "prudent person would exercise or use under the circumstances in the conduct of his own affairs."

To establish the amount of compensation, Judge Gross used the lodestar approach but pointed out that the noteholders did not object to the hourly rates charged by the indenture trustee's counsel.

Primarily, the noteholders objected to the time the indenture trustee's counsel spent on committee work. The noteholders contended that the indenture trustee did not need its own counsel when it could rely on the attorneys for the official committee. The noteholders also argued it would

be unreasonable to charge them for the indenture trustee's counsel's services designed to benefit the entire unsecured creditor body.

Judge Gross rejected the argument. He said the indenture authorized the trustee to "act through agents or attorneys" and to "consult with counsel of its selection."

Given the complexity of the case, Judge Gross said he would not "speculate" that the lawyers' participation in committee meetings was "imprudent." However, he did say it "was imprudent or unreasonable" to have more than one lawyer participate in meetings or review committee materials.

Significantly, Judge Gross differed with the 2005 decision by another Delaware bankruptcy Judge in *In re Worldwide Direct Inc.*, 334 B.R. 112 (Bankr. D. Del. 2005). There, the court did not compensate an indenture trustee for work that duplicated the services performed by committee counsel.

Judge Gross said he was "not convinced that *Worldwide Direct* is controlling law because it does not allow for an indenture trustee's forward thinking about issues in the case."

In evaluating fees, Judge Gross said the court should not exercise "hindsight" because "[i]t simply was implausible" for the lawyers or the indenture trustee "to know whether at the time they were performing the work that the Noteholders' interests did not need protection, or whether what they learned through the Committee would be of no benefit to the Noteholders."

Focusing on the trustee's duty to be prudent, Judge Gross said the "matters at hand were too important to leave to chance that the Committee Work would have no impact or significance to the Notes."

Relying on *Baker Botts*, the noteholders objected to paying the lawyers for defending their fees.

Rejecting the argument, Judge Gross said that the indenture was a contract between the parties authorizing departure from the so-called American Rule requiring each side to pay its own fees. He pointed to provisions in the indenture that called for payment of the indenture trustee's and its attorneys' fees incurred in a fee dispute.

The opinion is *In re Nortel Networks Inc.*, 09-10138 (Bankr. D. Del. March 8, 2017).

Lawyers can be nailed for misconduct under Section 1927, but not their clients.

Fees to Recover Sanctions Are Permitted under 28 U.S.C. § 1927

Whether a court can award "fees on fees" is a hot topic, exemplified by the Supreme Court's decision in *Baker Botts LLP v. Asarco LLC*, which holds that retained counsel cannot obtain compensation for successfully defending a fee application. In the appellate context, the Ninth Circuit laid down rules explaining when an injured party can recover fees incurred in obtaining a sanction against an adversary for a frivolous appeal.

Essentially, the expense of obtaining a monetary sanction can be recovered if the basis for the award is a fee-shifting statute. If the basis for the award is a rule that allows sanctions, "fees on fees" are not recoverable, according to a published-but-unsigned opinion by the Ninth Circuit on April 18.

In turn, the ability of a bankruptcy court to award "fees on fees" can depend on which side the circuit takes on the question of whether a bankruptcy court is a "court of the United States."

The Blixseth-Yellowstone Bankruptcy

The April 18 opinion followed a Ninth Circuit decision in August 2015 involving Timothy Blixseth, the former owner of the bankrupt Yellowstone Mountain Club, who at the time was in jail for civil contempt. The appeals court sanctioned Blixseth and his Boston lawyer, Michael J. Flynn, for taking a frivolous appeal that hurled "19 accusations of misconduct at a bankruptcy judge who had ruled against" him. The circuit said they failed "to back up their accusations 'with even a shred of credible evidence.'" The circuit judges also said that Flynn's "conduct has been unprofessional throughout."

The decision in August 2015 required Blixseth and his lawyer to pay $500 in costs plus the other side's attorneys' fees. The appeals court appointed an appellate commissioner to determine the amount to be paid.

After the commissioner decided that the sanction for the two amounted to almost $200,000, Flynn in effect appealed to the circuit judges on the panel that had called for the imposition of sanctions.

Section 1927 vs. Rule 11

In the Ninth Circuit, the pivotal precedent was *In re Southern California Sunbelt Developers, Inc.*, 608 F.3d 456 (9th Cir. 2010), where the appeals court held that Section 303(i) of the Bankruptcy Code, allowing imposition of sanctions following dismissal of an involuntary petition, is "a fee-shifting provision rather than a sanctions statute such as Rule 11."

Consequently, Section 303(i) permits awards of "fees on fees" in the Ninth Circuit, although a sanction under the court's inherent power does not.

In the case at hand, client Blixseth and his attorney Flynn were both sanctioned under F.R.A.P. 38; Flynn was also sanctioned under 28 U.S.C. § 1927, where the court may require an attorney to pay "the excess costs, expenses, and attorneys' fees reasonably incurred because of" vexatious conduct.

In contrast, Rule 38 of the appellate rules allows the court to award "just damages" for a frivolous appeal.

Because Section 1927 does not refer to "damages," the Ninth Circuit held that the cost of obtaining sanctions can be awarded under Section 1927 but not under Rule 38. The San Francisco-based appeals court therefore agreed with *Norelus v. Denny's, Inc.*, 628 F.3d 1270 (11th Cir. 2010).

The Ninth and Eleventh Circuits agree that an injured party would not be fully compensated without reimbursement of the "costs of obtaining the sanctions award."

Although Section 1927 has a "sanctions trigger," the Ninth Circuit's opinion says that the statute is properly "characterized as a fee-shifting provision." Furthermore, the appeals court said, Section 1927 allows compensation "*for the litigation as a whole*." [Emphasis in original.] Therefore, the Ninth Circuit held that "Section 1927 allows an award of attorneys' fees incurred in obtaining a sanctions award."

Bankruptcy Court & Section 1927

Is a bankruptcy court a "court of the United States" and therefore entitled to impose sanctions against counsel under Section 1927? On that question, the circuits are divided.

In June 2016, the Sixth Circuit joined the Second, Third and Seventh Circuits by holding that a bankruptcy court is a "court of the United States." The Ninth and Tenth Circuits have held that bankruptcy courts are not courts of the U.S. To read ABI's discussion of the Sixth Circuit case and the circuit split, click here.

In some circuits, therefore, a bankruptcy court could use Section 1927 to impose sanctions against counsel "for the litigation as a whole," assuming the Ninth Circuit is correct in its new decision.

Fodder for the Supreme Court?

"The decision is a product of judicial protectionism at the appellate level and outright corruption at the bankruptcy level," Flynn told ABI in an email in response to a request for comment.

Flynn went on to say, "I have been litigating for 47 years. The federal judiciary, like many institutions in our country, is broken. It is permeated with corrupt influences. [Circuit Judge] Kosinski has improperly shaped all of the *Yellowstone* decisions to protect [retired Bankruptcy Judge Ralph B.] Kirscher, including this latest. The truth will ultimately emerge notwithstanding judicial protectionism."

Flynn vowed to appeal to the Supreme Court and flagged a decision handed down by the high court on April 18, *Goodyear Tire & Rubber Co. v. Haeger*, 15-1406. Resolving a split of circuits, the unanimous Supreme Court reversed the Ninth Circuit by holding that a federal court, in exercising its "inherent powers," can impose a sanction, but one that is "limited to the fees that the innocent party incurred solely because of the misconduct."

In other words, Justice Elena Kagan said, the court may not impose sanctions equal to the expenses incurred in the entire litigation. The sanctions "must be limited to the fees the innocent party incurred solely because of the misconduct."

The ability of Flynn to rely on *Goodyear* may be limited, though, because the district court there utilized its inherent powers. Justice Kagan noted in a footnote that the district court could not use Section 1927 because the statute can only be employed against counsel and not against the company whose conduct was responsible for the wrongful withholding of documents in discovery.

The opinion is *Blixseth v. Yellowstone Mountain Club LLC*, 12-3598 (9th Cir. April 18, 2017).

Fees on Dismissal

With no circuit authority, lower courts are split on the fate of standing trustees' fees when a chapter 13 case is dismissed before confirmation.

No Statutory Fees for Standing Chapter 13 Trustees if Dismissal Precedes Confirmation

With no authority as yet from the courts of appeals, the lower courts are divided on the right of a standing trustee to retain his or her statutory fees if a chapter 13 case is dismissed before confirmation.

Bankruptcy Judge Mary Ann Whipple of Toledo, Ohio, decided that the "plain language" of Section 1326(a)(2) takes precedence over 28 U.S.C. § 586(e), which "lacks such clarity," she said.

The case involved joint chapter 13 debtors who paid about a $10,500 to the standing chapter 13 trustee. The plan was never confirmed, and the case was dismissed. The bankruptcy court approved the trustee's final report and dismissed the case, calling for the trustee to retain about $900 in statutory fees and return the remainder to the debtors.

One of the debtors sought reconsideration, disallowance of the trustee's statutory fees, and disgorgement of the fee that the trustee had retained.

In her Sept. 29 opinion, Judge Whipple said that the *Handbook for Chapter 3 Standing Trustees*, published by the Executive Office of the U.S. Trustees, provides no guidance. If a chapter 13 case is dismissed before confirmation, the *Handbook* says that the standing trustee must reverse the payment of the percentage fee "if there is controlling law in the district requiring such reversal."

The *Handbook* is equivocal because, as Judge Whipple said, the two controlling statutes point in different directions.

Section 1326(a)(2) says that if a plan is not confirmed, "the trustee shall return any [payments made by the debtor] not previously paid out and not yet due and owing to creditors . . . to the debtor, after deducting any unpaid claim allowed under Section 503(b)."

Seemingly to the contrary, Section 586(e) provides that the standing trustee "shall collect such percentage fee from all payments received by [the standing trustee] under plans in the cases under" chapters 12 and 13.

Judge Whipple said that none of the courts of appeals had resolved the conflict in the two sections, and the lower courts are in disagreement. She said there is no controlling law in her district.

In deciphering which statute to follow, Judge Whipple said that the "plain language of Section 1326 is clear." When a chapter 13 case is dismissed before confirmation, she said that use of the word "shall" requires the standing trustee "to return all such payments, including the statutory percentage fee being held by the trustee, after deducting any allowed administrative expense claims."

By comparison, Judge Whipple said that Section 586(e)(2) "lacks such clarity," in part because it deals with collection but not ultimate disposition.

Consequently, Judge Whipple granted the motion for reconsideration, modified the dismissal order, and required the trustee to pay the statutory fee to the debtor.

The opinion is *In re Lundy*, 15-32271 (Bankr. N.D. Ohio Sept. 29, 2017).

Harris v. Viegelahn ***extended from chapter 13 conversions to dismissals.***

After Chapter 13 Dismissal, Counsel Fees Aren't Paid

Although *Harris v. Viegelahn*, 135 S. Ct. 1829, 191 L. Ed. 2d 783 (2015), seemingly answered the question, a lawyer for a chapter 13 debtor evidently didn't get the message and sought payment of fees from money held by the trustee after dismissal of a chapter 13 case.

Bankruptcy Judge Jeffrey P. Norman of Shreveport, La., gave undistributed wages to the debtor and precluded the attorney from collecting directly from the debtor.

After making payments for two years under a confirmed plan, the debtor voluntarily dismissed his chapter 13 case. Two weeks later, his counsel filed a $350 fee application for preparing an amended plan that was never filed. From wages paid to the trustee by the debtor's employer, the trustee had funds sufficient to pay the requested fees.

In his March 31 opinion, Judge Norman ruled that the fee application was moot because any money held by the trustee would be paid to the debtor, leaving nothing for payment of administrative expenses.

In *Harris*, the Supreme Court ruled that the debtor was entitled to receive undistributed wages held by the chapter 13 trustee on conversion to chapter 7. The Court held that turning the money over to the debtor was not a windfall.

Before *Harris*, courts were split on whether counsel could be paid from undistributed wages after a chapter 13 case was dismissed. Finding *Harris* to be "equally appropriate" when the chapter 13 case was dismissed instead of being converted, Judge Norman followed the majority and gave the money to the debtor.

Judge Norman held that Section 349(b)(3) "is unambiguous." At dismissal, he said, "all of the debtor's post-petition earnings revest in the debtor unless the court orders otherwise for cause." There being no "cause," the debtor was entitled to recover his undistributed wages.

The debtor's counsel would not be the only claimant entitled to the money if it didn't go to the debtor. Figuring out how to distribute a small amount of money among multiple claimants with differing priorities would be difficult and expensive, Judge Norman said. In any event, counsel fees had no special priority to the exclusion of other creditors.

Judge Norman also barred the lawyer from collecting the fees directly from the debtor. He said that "dismissal should not lead to additional obligations for the debtor."

The opinion is *In re Demery*, 13-10783 (Bankr. W.D. La. March 31, 2017).

Compensation

Terms of fee sharing must be disclosed in the retention application, not just in an exhibit.

Cryptic Disclosure of Fee Sharing Is Inadequate, Judge Houser Holds

Attaching a fee sharing agreement to a retention application is insufficient, according to Bankruptcy Judge Barbara J. Houser of Dallas, who ruled that the terms of a fee sharing arrangement must be "expressly disclosed in the body" of an employment application.

A chapter 13 debtor's bankruptcy counsel hired a law firm to serve as special counsel in the prosecution of a lawsuit against a lender. The two firms had a fee sharing agreement where bankruptcy counsel would receive the greater of 25% of special counsel's allowed fees or bankruptcy counsel's time charges.

Judge Houser had approved special counsel's retention. The propriety of the fee sharing agreement did not come into focus until special counsel filed a fee application following successful prosecution of the suit against the lender.

Although the fee sharing agreement had been attached as an exhibit to the employment application, Judge Houser said in her June 9 opinion that fee sharing was only "cryptically referenced" in the application itself. Despite concluding that counsel had not "intentionally misled" the court, she said that disclosure was "less than complete," given disclosure requirements in Section 329(a) and Bankruptcy Rules 2014(a) and 2016(b).

Judge Houser said that inadequate disclosure "is grounds for this court to reduce (or even deny in full) its fees." Although she decided that "a monetary sanction of some sort should be imposed," Judge Houser let special counsel off the hook by reducing that firm's fees by only 25%, the amount the firm had agreed to share in violation of the fee sharing prohibition in Section 504.

Section 504(a) bars the sharing of fees with someone else, apart from exceptions in Section 504(b) and (c) that were not applicable in this case. Special counsel contended that Section 504 was inapplicable because the settlement agreement with the lender required the lender to pay the court-approved attorneys' fees.

Even though the bank would pay the fees, Judge Houser concluded that Section 504 was nonetheless applicable, since courts "have long recognized that fee sharing between attorneys in bankruptcy cases violates public policy." Otherwise, she said, lawyers could evade Section 504 by having fees paid by third parties.

Judge Houser cancelled the fee sharing agreement, finding that it was prohibited by Section 504(a). She therefore precluded bankruptcy counsel from sharing any of the fees allowed to special counsel.

The opinion is *In re Harris-Nutall*, 14-35300 (Bankr. N.D. Tex. June 9, 2017).

Lawyers can't be reimbursed for advancing filing fees through fee applications or 'no-look' fees.

Counsel Must Eat Filing Fees in 'No-Money-Down' Chapter 13s

In a "no-money-down" chapter 13 practice, the debtor's counsel cannot obtain reimbursement of filing and credit-counseling fees on top of a "no-look" fee, according to Bankruptcy Judge John W. Kolwe of Alexandria, La.

Although Judge Kolwe was interpreting his district's new local rule on no-look fees, his rationale would preclude reimbursement of a filing fee even if sought as part of a fee application under Section 330(a).

In his Sept. 29 decision, Judge Kolwe said that "virtually all" chapter 13 attorneys in his district file so-called no-money-down cases where the lawyer pays the filing fee, the credit-counseling fee, and the fee for a credit report. Advancing fees is helpful for cash-starved consumers who cannot afford the fees, let alone the pre-filing retainer for chapter 7, for which many debtors would be eligible if they could afford counsel's retainer "up front."

Until Feb. 1, 2017, the Western District of Louisiana explicitly provided that reimbursement for any filing or credit-counseling fees had to be included in the no-look fee. As a result, Judge Kolwe said, the prior local rule effectively forced the lawyers "to absorb those costs."

Effective Feb. 1, the Western District's new no-look rule has been silent about reimbursement of filing fees paid by counsel. As a result, lawyers began filing chapter 13 cases calling for payments under the plans to cover both the no-look fees and reimbursements of the filing, counseling, and credit-search fees.

With the chapter 13 bar participating, Judge Kolwe selected one debtor's plan to test whether the new local rule would allow reimbursement of advanced fees on top of no-look fees. He concluded that chapter 13 counsel are not entitled to reimbursement of costs they advance to permit no-money-down filings.

First, Judge Kolwe ruled that counsel could not obtain reimbursement of the fees as an administrative expense under Section 503(b)(1)(A), because they are "prepetition expenses of the debtor, not the estate." Furthermore, he said, the reimbursement obligation arose from the pre-petition retention agreement between the debtor and the attorney, not "from a transaction with the debtor's bankruptcy estate." In addition, the expenses advanced by the lawyer did "not provide a direct and substantial benefit to the estate."

Similarly, the filing, credit-counseling and credit-search fees are not reimbursable under Sections 330(a)(4)(b) and 503(b)(2).

Quoting a Georgia bankruptcy court opinion from earlier this year, Judge Kolwe said that filing fees are not reimbursable because they are the debtor's "cost of admission." The cost of filing fees cannot be shifted to the estate unless the debtor obtains an order authorizing the payment of the filing fees in installments.

The opinion is *In re Riley*, 17-80108 (Bankr. W.D. La. Sept. 29, 2017).

Other Notable Ethics Questions

Advice without signing a pleading does not give rise to a Rule 9011 sanction, but Section 1927 is another story.

BAP Strictly Requires Signing a Pleading for a Rule 9011 Sanction

The Sixth Circuit Bankruptcy Appellate Panel read the statute and rules narrowly to protect a lawyer from sanctions, even though the lawyer made an error that cost his clients dearly. The opinion could be read to mean that sanctions are not a shortcut to imposing liability for malpractice.

The focus of the Nov. 7 opinion was a lawyer whom the bankruptcy judge referred to as the "shadow lead counsel" for a couple in chapter 7. Although the lawyer was not experienced in bankruptcy, he advised the couple not to list their interest in a trust in their schedule of assets, on the faulty theory that the trust was not an asset of theirs.

The petition was signed by another attorney that the lawyer had the couple hire to be their principal counsel in the bankruptcy.

The chapter 7 trustee discovered the existence of the trust. In the ensuing lengthy and complex litigation, in which the lawyer sometimes participated, the bankruptcy court denied the debtors' discharges for submitting a false oath by neglecting to schedule the trust. The judge rejected the debtors' advice of counsel defense.

The bankruptcy court then granted standing to a creditor to mount a malpractice action on behalf of the estate against the lawyer. Contending that the bankruptcy never should have been filed, the creditor also sought sanctions under 28 U.S.C. Section 1927 and Bankruptcy Rule 9011. The creditor gave the lawyer neither notice of the pleadings that were allegedly sanctionable, nor an opportunity to withdraw them.

Deciding the facet of the motion based on Section 1927, the bankruptcy judge found a violation of the statute because the lawyer's "shadow representation of [the] debtors in the bankruptcy case and in the adversary proceeding vexatiously and unreasonably multiplied the proceedings."

On the arm of the motion under Rule 9011, the bankruptcy judge found liability from the failure to schedule assets because the lawyer was "acting as lead counsel from the shadows."

Without resolving the malpractice suit, the bankruptcy court sanctioned the lawyer by requiring him to disgorge fees received before bankruptcy and attend courses on legal ethics.

The lawyer appealed and won, in an opinion by Bankruptcy Judge C. Kathryn Preston of Columbus, Ohio.

The reversal turned in large part on the so-called safe harbor in Bankruptcy Rule 9011(c)(1)(A), which precludes a court from imposing sanctions unless the moving party has given 21 days' notice to withdraw the allegedly offending filings. The safe harbor contains an exception, however, saying that notice and opportunity to withdraw is not required when the allegedly offending conduct is the "filing of a petition."

The safe harbor exception exists, Judge Preston explained, because the filing of a petition has "'immediate serious consequences . . . which may not be avoided by the subsequent withdrawal of the petition.'"

Focusing on the "plain language" of Rule 9011, Judge Preston absolved the lawyer of liability under the rule because he did not sign the petition. The judge said there is no authority for the proposition that exerting influence over the contents of a petition and schedules "is the equivalent to having filed them."

The creditor argued that Rule 9011 did not require notice because the allegedly offending documents were the petition and schedules. Judge Preston found the exception inapplicable because it only applies to the filing of a petition, which the lawyer neither signed nor filed.

The lawyer therefore had no Rule 9011 liability because he was not given notice and an opportunity to withdraw offending pleadings.

Judge Preston also reversed the finding of liability under Section 1927, which allows the imposition of sanctions for "unreasonably and vexatiously" multiplying proceedings.

The BAP held that opposing the discharge litigation and attempting to justify the failure to schedule the trust were neither unreasonable nor vexatious, because the bankruptcy court did not find that the lawyer "knew or should have known that the claim he was pressing was frivolous." The panel said that "mere incompetence or negligence" does not justify Section 1927 sanctions.

The opinion is *Grusin v. Church Joint Venture LP (In re Blasingame)*, 14-8046 (B.A.P. 6th Cir. Nov. 7, 2016).

Two ethical lapses resulted in a nondischargeable debt.

Violation of Professional Ethics Resulted in a Nondischargeable Debt

Disregarding ethical obligations can result in the denial of discharge of a debt owing by a lawyer, as demonstrated by a May 8 opinion from the Fifth Circuit. In substance, the lawyer converted a dischargeable debt into a nondischargeable debt by violating rules of professional ethics.

A lawyer neglected to file a lawsuit before the statute of limitations elapsed. Confessing his sin to the client, the lawyer offered to make good by giving her a note for $275,000, the value of the lawsuit. The lawyer said he had no malpractice insurance and no other way to pay her. The lawyer said he had a case that might pay out and enable him to make good on the note.

Almost two years later, and after the statute of limitations had elapsed on the client's ability to mount a malpractice suit, the client filed suit in state court on the note. The lawyer responded by filing a chapter 7 petition.

The bankruptcy court ruled that the debt was nondischargeable under Section 523(a)(2)(A) for "an extension of credit . . . to the extent obtained by . . . false pretenses, a false representation, or actual fraud . . . ." The district court affirmed.

For the Fifth Circuit, Circuit Judge Edward C. Prado upheld the bankruptcy court, ruling first that the note was an extension of credit because it gave the lawyer more time to pay.

Judge Prado then turned to the question of whether there was actual fraud. To prove actual fraud, he said the client had to show that (1) the debtor made a representation, (2) that the debtor knew to be false at the time, (3) that was made with intent and purpose to deceive, (4) the creditor relied on the representation, and (5) the creditor sustained losses as a proximate result.

The significance of the opinion lies in Judge Prado's holding that disobeying state rules of professional conduct represented the false representation required by Section 523(a)(2)(A).

The Louisiana Rules of Professional Conduct prohibit a lawyer from settling a malpractice claim without advising the client in writing "of the desirability" of obtaining independent legal advice. The debtor-lawyer never made the required disclosure to the client-creditor.

Judge Prado said that courts "have overwhelmingly held" that a "debtor's silence regarding a material fact can constitute a false representation actionable under Section 523(a)(2)(A)." He relied

in large part on a Tenth Circuit opinion holding that a failure to disclose a potential conflict of interest amounted to a false representation.

Having identified a false representation, Judge Prado massaged the record and encountered no errors in the bankruptcy court's findings of fact to satisfy the other elements of a nondischargeable debt.

The opinion is *Selenberg v. Bates (In re Selenberg)*, 16-30649 (5th Cir. May 8, 2017).

Appeals court was reluctant to let lawyers off the hook for allegedly unethical conduct.

Second Circuit Limits *Res Judicata* Effect of Prior Bankruptcy Proceedings

Trimming back the doctrine of *res judicata*, the Second Circuit held that a prior litigation between the same parties, involving the same facts, may not invoke *res judicata* when the prior proceeding was a bankruptcy. The outcome may have been influenced by the appeals court's desire to prevent a technicality from insulating lawyers from liability when the bankruptcy judge was never aware of the lawyers' alleged conflicts of interest.

The April 14 opinion by Circuit Judge Peter W. Hall shows the peril that befalls lawyers who attempt to maximize income by taking on too many roles and switching clients midstream.

The Facts Are Necessary to Understand the Result

The appeal came to the Second Circuit from an order granting a motion to dismiss. Judge Hall therefore construed the allegations in a light most favorable to the plaintiffs. The following factual summary should also be understood as allegations, not findings of fact.

A law firm was hired by a company's executives to devise a strategy for them to buy the company and keep it out of the clutches of secured lenders. When an out-of-court transaction became infeasible, the lawyers advised the executives to buy the business through a bankruptcy sale in chapter 11. The lawyers helped the executives incorporate their acquisition vehicle.

The lawyers told the executives that they were interested in representing the company in chapter 11. Without obtaining a waiver from the executives, the company retained the lawyers as their reorganization counsel. The executives included the chief executive and the inside general counsel, who presumably made the decision for the company to hire the lawyers they were using.

Perhaps while representing both the company and the executives, the firm prepared an asset-purchase agreement and advised the executives on how they could maximize the chance that the bankruptcy court would anoint them as the top bidder. The firm also helped the executives arrange financing for the acquisition.

Shortly before bankruptcy, the lawyers told the executives to retain their own counsel, who turned out to be a former partner. By that time, Judge Hall said, most of the acquisition agreement had been drafted.

When the company filed chapter 11, the lawyers did not disclose their prior representation of the executives.

Once in bankruptcy, the company's secured lender sought to buy the business in exchange for debt. In his lawsuit against the lawyers that led to the appeal, the former chief executive of the debtor contended that the lawyers did not fully disclose their connections with the lender.

In substance, the chief executive alleged that the lawyers used knowledge they gained about him to swing the bankruptcy sale in favor of the lender.

Although the company officers initially won the auction, the chief executive blamed the lawyers' inaction for causing the loss of financing that prevented him from closing the acquisition. The bankruptcy court eventually approved a sale to the lender, which was followed later by confirmation of a plan.

Judge Hall said that the bankruptcy judge was not aware of the lawyers' potential conflicts until a year after confirmation.

After the sale to the lender closed and the company confirmed a chapter 11 plan, the debtor's former chief executive sued the lawyers in federal district court in Brooklyn, N.Y., alleging breach of fiduciary duty, failure to obtain a waiver for dual representation, and common law fraud, among other things. The former executive was not seeking to unravel the sale. Rather, he sought monetary damages to put him financially in the same position as though he had been the successful buyer.

Dismissal in District Court

In district court, the lawyers filed a motion to dismiss and won. They contended that the sale-approval and confirmation orders were *res judicata*, barring the later suit for ethical misconduct occurring before and during the chapter 11 case.

Employing *res judicata* to dismiss the suit, the district judge characterized the complaint as a "thinly disguised collateral attack" on the bankruptcy orders. The district judge believed that granting relief to the executives would require him "to effectively overrule" the bankruptcy court's orders.

Res Judicata Is Awkward in Bankruptcy

Judge Hall recited the usual rules about *res judicata*, sometimes called claim preclusion. It requires a final decision on the merits, the same parties or their privies, competent jurisdiction in the prior court, and the same causes of action that were or could have been brought.

In substance, the lawyers contended that the suit was barred by *res judicata* because their ethical misconduct could have been raised in bankruptcy court to block the sale to the lender. Although conceding that the executives could have raised the lawyers' alleged conflicts in bankruptcy court, Judge Hall said that "the standard *res judicata* analysis can be an awkward fit when applied to bankruptcy proceedings."

In ordinary civil litigation, courts focus on whether claims could have been brought in a prior action, Judge Hall said. In bankruptcy, the judge said, the question is whether the new suit "seeks to bring claims that could have been raised and litigated *within the scope of the bankruptcy proceeding*," citing Second Circuit precedent. [Emphasis added.] From that point on, the opinion became an exploration of the subtle differences between the *res judicata* standards for bankruptcy and non-bankruptcy cases.

Evidently, Judge Hall would have invoked *res judicata* had the chief executive based his lawsuit on the notion that there was collusion between the law firm and the eventual buyer, an issue that would have gone to the heart of the bankruptcy court's decision to approve the sale to the lender. Instead, he said that collusion was not the "gravamen" of the complaint. Rather, he said, the complaint focused only on the misconduct of the lawyers alone and not in conjunction with the lender.

Judge Hall said the executives could have raised the lawyers' misconduct during the sale-approval proceedings. Nonetheless, he said that disqualifying the lawyers "would not have provided [the chief executive] a fair forum in which to litigate fully the claims [he] now brings against them." In other words, even successfully blocking the sale to the lender "would not have been equivalent to asserting the present claims."

Significantly, Judge Hall said that the "circumstances did not demand that plaintiffs raise their claims in the bankruptcy proceeding." What those circumstances were is not entirely clear. Does the opinion mean that a bidder is not required to raise allegations of misconduct during the sale process? That hardly seems likely, but the opinion might be cited for that principle.

Ordinarily, a counterclaim not raised in prior litigation can be barred by *res judicata* in a non-bankruptcy context. When the prior litigation was in bankruptcy, perhaps the decision means that *res judicata* will not apply when a non-debtor would have been required to initiate an adversary proceeding against another non-debtor to obtain monetary damages or other relief that would not have been available by merely opposing relief sought in the pending contested matter.

In any event, Judge Hall disagreed with the district court's conclusion "that the [executives] could have, and should have, raised their present claims in the bankruptcy proceeding." That statement is puzzling, because the executives could have raised claims against the lawyers in bankruptcy court. Indeed, wearing their fiduciary hats as executives of a bankrupt company, perhaps they should have raised the ethical questions before the bankruptcy judge. Whether the

bankruptcy court may have deflected jurisdiction beyond sanctioning the lawyers is another question.

Judge Hall ended the opinion by saying that giving monetary damages to the executive in the new lawsuit "will have no effect on the continuing validity of the bankruptcy court's order approving the sale."

What Happens Next?

Having the lawsuit reinstated does not mean the former chief executive will eventually win. Arguably, he was happy with dual representation and lack of disclosure when bankruptcy seemed to be working in his favor. Perhaps the doctrine of unclean hands or some other equitable defense will bar a recovery, because the executive was working in conjunction with the company's inside counsel to buy the business, and the inside attorney should have been aware of the ethical question and failure to disclose the pre-bankruptcy representation of the insider buyout group.

Courts will likely read the decision narrowly to avoid collateral attacks on sale orders by disgruntled bidders. The opinion may be confined to its precise facts: *Res judicata* will not apply where an unsuccessful bidder sues its own lawyer for a conflict, and the bankruptcy court ordinarily would not dispense monetary damages to the non-debtor client.

If nothing more, the case is a fine example of ethical problems that confront lawyers when they wear too many hats, and especially when there was no informed consent and waiver by the clients.

The opinion is *Brown Media Corp. v. K&L Gates LLP*, 15-4185 (2d Cir. April 14, 2017).

First Circuit narrowly applies equitable mootness in a receivership sale.

First Circuit Narrowly Defines Fiduciaries Who Are Prohibited Buyers of Estate Assets

The First Circuit is receptive to the notion that estate professionals in some circumstances can purchase estate property.

In a receivership, the receiver had hired a sales agent to market some of the estate's intellectual property. After two years, the agent was able to negotiate a sale of only a portion of the intellectual property.

Ultimately, the receiver proposed selling several parcels of real property, the remaining intellectual property, and some other assets to an affiliate of the agent. The receiver disclosed the relationship between the agent and the proposed buyer and told the district judge that the affiliate was in the business of purchasing property for resale.

The district court approved the sale, but the individual whose property was in receivership appealed to the First Circuit.

Circuit Judge Sandra L. Lynch upheld the sale in an opinion on Oct. 17, holding that the agent's affiliate was a permissible purchaser.

The appellant argued that the transaction amounted to the prohibited sale of estate assets to a fiduciary. Judge Lynch narrowly defined the types of fiduciaries who are prohibited from purchasing estate property.

She began by citing First Circuit precedent saying that "a full-fledged fiduciary, such as a trustee or court-appointed receiver," is "normally" prohibited from purchasing estate property, "even if the terms are fair."

The agent, however, was not a "full-fledged fiduciary" who would be subject to automatic disqualification, Judge Lynch said.

Fiduciaries, she said, are disqualified because "there is no one else who can similarly protect the estate's interest." In the case at bar, the receiver "had control over the receivership assets and protected the estate's interests," Judge Lynch said. She also said that the agent "did not have effective control over the estate's [intellectual property]; it was merely responsible for marketing them."

The precedential value of the opinion may be limited because the appellant was an unattractive litigant. As the target of the receivership, the appellant had "obstructed" the receivership "throughout," according to findings by both the appeals court and the district court. Since the receivership was seven years old, the district judge had instructed the receiver to conclude the sale quickly and close the receivership.

Thus, the appellant's own actions may have contributed to ending up with a less-than-ideal buyer.

Judge Lynch's opinion demonstrates why Section 363(m) is a necessary component of the Bankruptcy Code. That section provides that reversal of a sale-approval order does not affect the validity of the sale to a good-faith purchaser, so long as there was no stay pending appeal.

The receiver had argued that equitable mootness should result in dismissal of the appeal, without reaching the merits. Judge Lynch rejected the receiver's reliance on a First Circuit decision, saying that case pertained "only to statutory mootness under [Section 363(m)], which does not apply here."

Otherwise, Judge Lynch said that the appeal was not equitably moot because the affiliate was still in possession of the purchased property, and no third parties would be harmed if the sale were set aside.

The opinion is *Gangi v. Jenkins*, 16-1048 (1st Cir. Oct. 17, 2017).

Financing litigation is champertous if the lender exercises control.

Litigation Funding Could Be Champertous in Some States

In states where champerty and maintenance are still banned, financing litigation could prove impossible if lawyers are unwilling to undertake the case on a contingency, as shown by a decision from North Carolina.

A litigation trust had sued former officers and directors in "titanic litigation" where Bankruptcy Judge J. Craig Whitley of Charlotte, N.C., said the costs were "already monumental." Since her lawyers were unwilling to continue the suit entirely on a contingency, the trustee arranged for financing from a hedge fund.

In a Jan. 20 opinion where he said "the practice of litigation funding is in its infancy," Judge Whitley refused to approve the financing because it was champertous.

Judge Whitley said that some states, like California and Connecticut, either now allow arrangements that would have been champertous or never adopted the prohibitions in the first place. North Carolina, he said, "has retained the proscriptions against champerty and maintenance."

He described champerty and maintenance as occurring "when two or more parties make an arrangement to divide the proceeds of litigation between the owner of the chose in action and the party who either supports or acts to enforce the litigation." The "key inquiry," Judge Whitley said, is "whether that party 'exercised control over the claim.'"

In the case at hand, the hedge fund would make advances once a quarter. From proceeds of successful litigation, the hedge fund would first recover its advances and then a specified percentage of the net. The trustee's lawyers also would get a percentage of recoveries plus reduced time charges that would have been paid from quarterly advances.

Judge Whitley concluded that the funding agreement was champertous because the hedge fund could "control the litigation in a number of ways." In addition to cutting off funding at any time, the hedge fund had the right to consult over the substitution of attorneys.

The primary flaw in the arrangement was the hedge fund's right to decide every quarter whether to continue funding or not. Judge Whitley said the agreement allowed the hedge fund "to weigh whether its involvement continues to be a profitable endeavor and whether continued funding is in its, rather than the debtor's creditors', best interest."

The opinion is *In re Designline Corp.*, 13-31943 (Bankr. W.D.N.C. Jan. 20, 2017).