UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA

IN RE:	)	
	)	
Carolina Premier Medical Group, P.A.	)	**Case No. 00-82322**
	)	
Debtor.	)	
	)	

MEMORANDUM OPINION

This matter came on for hearing on the "Request for Hearing on Application for Final Compensation of Northern Blue, L.L.P. Heard Prior to the Closing of the Chapter 7 Case." Appearing before the court were John A. Northen, Counsel for the Debtor and the Applicant herein, Sara Conti, the Chapter 7 Trustee and Michael D. West, Bankruptcy Administrator.

The issue before the Court is whether the retained monies remaining in the Trust Account of Northen Blue should be paid to the law firm or paid to the Chapter 7 Trustee. For the reasons set forth herein, the Court finds that the monies held in the Trust Account of Northen Blue at the time the case converted from Chapter 11 to Chapter 7 should be paid to Northen Blue as part of their approved attorney's fees and not remitted to the Chapter 7 Trustee.

BACKGROUND

This bankruptcy proceeding was commenced by the Debtor filing a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on September 8, 2000. The Debtor retained John A. Northen and the firm of Northen Blue, L.L.P. to act as counsel, and the Debtor filed an "Application for Approval to Employ Attorney for Debtor" on September 8, 2000. The Application disclosed that counsel had agreed to represent the Debtor for such compensation as may be subsequently allowed in accordance with the Bankruptcy Code. Counsel for the Debtor

also filed an affidavit pursuant to Rule 2016, to disclose any pre-petition payments for a retainer paid to his firm. In that affidavit, counsel disclosed that the firm had received $89,125.00 prior to the commencement date, of which $16,635.00 was applied in payment of pre-petition services (including the filing fee), and the balance of $72,490.00 had been deposited in counsel's trust account as a retainer for post-petition fees and expenses as may be allowed by the Court. By Order dated September 8, 2000, this Court approved the employment of counsel pursuant to the application.

On the 7th day of March 2001, the case was converted from Chapter 11 to Chapter 7. At that time $3,425.25 of the retainer remained in the trust account after the payment of fees and expenses previously approved during the Chapter 11 proceeding.

Counsel for the Debtor filed a final fee application for the services rendered during the Chapter 11 period, seeking allowance of additional fees and expenses in the aggregate amount of $7,753.02, an amount which exceeded the amount left in the retainer. Counsel requests that the Court rule on the final fee application and if approved, that the amount left in the retainer be applied in payment of allowed fees and expenses without further delay. The Bankruptcy Administrator takes the position that the monies should be turned over to the Chapter 7 Trustee as unrestricted funds.

DISCUSSION

A. Disclosure Requirements

The Court cannot think of any area of the practice of law in which the retention of professionals is so closely scrutinized. Section 329 (a) requires the debtor's attorney to disclose the terms of any pre-petition retainer agreements to the court. Bankruptcy Rule 2014 requires the filing of an application for employment that sets forth specific facts including any proposed

arrangement for compensation. The application must set forth, by an accompanying verified statement, counsel's connections with the debtor, creditors, or any other party in interest. This disclosure is a continuing duty for the duration of the bankruptcy case. In re Granite Partners, L. P., 219 B.R. 22 (Bankr. S.D.N.Y. 1998). Under Rule 2016 an attorney seeking compensation, must, among other items, set forth the sources of the compensation paid or promised and whether any compensation previously received has been shared and if so with whom and under what terms. Rule 2017 permits any party in interest, or the court on its own initiative, to hold a hearing to determine whether the transfer of money or transfer of property by the debtor, directly or indirectly, pre or post-petition, to the debtor's attorney, constitutes excessive payment for services.

The failure to comply with any of these disclosure requirements may result in severe sanctions. In re Crayton, 192 B.R. 970 (BAP 9th Cir. 1996) (an attorney who fails to comply with the disclosure requirements forfeits any right to receive compensation); In re Keller, 248 B.R. 859 (Bankr. M.D. Fla. 2000) (disgorgement of entire retainer for failure to comply with § 329).

In the case at hand, Northern Blue made all the required disclosures and indicated that the balance of the retainer, $72,490.00 had been deposited in counsel's trust account as a retainer for post petition fees and expenses as may be allowed by the Court. At the time of the conversion of the case $3,425.25 remained in the trust account and Northern Blue had not yet filed for all fees and expenses incurred through the date of conversion.

B. Disposition of Funds in Retainer Account

In this case, all parties agree that the retainer is property of the estate.[1] There are three different general approaches to the disposition of retained funds upon conversion from Chapter 11 to Chapter 7 which are based on the premise that retained funds are property of the estate. The first approach is that the pre-petition retainer is property of the estate in which counsel holds a security interest or lien arising under state law, pursuant to either the UCC or a specific state statute regarding attorney's liens. In re Dees Logging, Inc. 158 B.R. 302 (S.D. Ga. 1993) and In re Mathews, 154 B.R. 673 (Bankr. W.D. Tex. 1993). The second position is that the retained funds are property of the Chapter 7 estate held subject to a trust in favor of the attorney in order to compensate for services to be rendered during the Chapter 11 phase of the case. In re Kinderhaus Corp., 58 B.R. 94 (Bankr. D. Minn 1986). The third position is that the retainer is property of the estate and there is no cognizable interest in the retained funds which allows counsel priority over other administrative claims once converted to Chapter 7. Therefore, such funds may not be used to pay claims in any way other than as set forth in Section 726(b). In re Printcrafter, Inc. 208 B.R. 968, 975 (Bankr. D. Colo. 1997) and In re Rittenhouse, 73 B.R. 610, 611 (Bankr. S. D. Ohio 1987).

This court finds that the first approach is the better reasoned view and that the prepetition

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[1]The majority of bankruptcy courts hold that pre-petition retainers and are property of the estate. In re Printing Dimensions, Inc. 153 B.R. 715 (Bankr. D. Md. 1993); Collier, § 328.02 [1][d]; citing Steward v. Law Offices of Dennis Olson, 93 B.R. 91 (N.D. Tex 1988), aff'd 878 F.2d 1432 (5th Cir. 1989); In re Zukoski, 237 B.R. 194, 197 (M.D. Fla. 1998); In re Turner Corp., 243 B.R. 575 (Bankr. D. Mass 2000). However, there are some cases that hold that a retainer are not property of the estate due to the nature of the retainer agreement. In re McDonald Bros Costr. Inc. 114 B.R. 989 (Bankr. N.C. Ill. 1990) (Bankruptcy Code does not render all pre-petition retainers property of the estate); In re D.L.I.C., Inc., 120 B.R. 348 (Bankr. S.D.N.Y. 1990) (creditors failed to present sufficient evidence that the $17,000 prepetition retainer should be regarded as property of the estate).

retainer is property of the estate in which counsel holds a security interest. While federal bankruptcy law determines whether certain property is property of the estate; the Court looks to state law to determine the validity and extent of an interest in property. Butner v. United States, 440 US 48, 99 S. Ct 914 (1979). Northen Blue's interest in the funds held in the trust account is governed by the treatment of the retainer agreement under state law. There are several types of retainer agreements. A "classic retainer" is a fee paid by the client to secure the attorney's availability for a period of time. In re McDonald Bros Costr. Inc. 114 B.R. 989, 998 (Bankr. N.C. Ill. 1990). The comment to Rule 1.5 of the Rules and Regulations of the North Carolina State Bar suggests that in some instances, this type of non refundable retainer is permitted in North Carolina. The retainer is used to reserve the availability of the attorney, usually in the context of criminal defense practice. A second type of retainer is an "advance payment" retainer in which a client pays in advance for services to be rendered. Id. Finally, an attorney may require a "security retainer," which permits the attorney to hold the funds in his trust account to secure payment for fees and expenses for future services. Id.

In this instance, the retainer charged by Northen Blue was a security retainer. North Carolina does not have a statute that specifically grants a lien on funds held in the attorney trust account; however, the Rules and Regulations of the North Carolina State Bar do provide for such retainers. All lawyers that practice in North Carolina are required to adhere to the Rules and Regulations of the North Carolina State Bar. Pursuant to Rule 1.5(2) a lawyer may require advance payment of a fee, but, with limited exceptions, is obliged to return any unearned portion. Pursuant to 1.16(d), an attorney discharged by his client is entitled to recover the reasonable value of the services he has already rendered. The reasonable value of the services is determined by the totality of the circumstances of each case. O'Brian v. Plumides, 79 N.C. App. 159, 339 S.

E. 2d. 54, cert. dismissed, 318 N.C. 409, 348 S.E. 2d. 805 (1986).

It is accepted practice for counsel for Debtor to be paid a retainer in a Chapter 11 proceeding. In any Chapter 11 case, counsel for the Debtor takes on the risk that they may not be paid in full for the services that they render. In many instances, once counsel for the Debtor has depleted all monies in the trust account, counsel for the Debtor will forgo the payment of approved fees and expenses so that the Debtor can make adequate protection payments or make payments to key vendors. Counsel for the Debtor may defer payment in the hopes that the plan will ultimately be successful. However, as an inducement to take on a Chapter 11 case, counsel for the Debtor has the right to request a retainer. The retainer serves the purpose for which it is intended: collateral for services to be rendered in a bankruptcy proceeding in which full payment may not be afforded to administrative expense claimants. The status as a secured creditor does not disqualify the attorney from being retained by the estate as required by §327 of the Code. See In re NBI, Inc. 129 B.R. 212 (Bankr. D. Colo. 1991) and In re K & R Mining, Inc., 105 B.R. 394 (Bankr. N. D. Ohio 1989).

The security retainer is held by the attorney to secure payment of fees for future services that the attorney is expected to render. No funds may be paid from the trust account until such time as the fees and expenses have been noticed for hearing, the parties are given an opportunity to object, and the court has ruled on the reasonableness of the fees. See In re MacDonald Bros. Constr. Inc., 114 B.R. at 999. Under this analysis, the funds remain property of the estate until the attorney applies for the payment of funds for services rendered. If the Court finds that there are excess funds available in the retainer account then the monies would become available for the payment of other administrative fees. In re NBI, Inc. 129 B.R. 212 (pre-petition earned retainers are unreasonable in bankruptcy as they nullify code protections, therefore, such retainers remain

property of the estate required to be held in trust by counsel and may be drawn against only with court approval). At the conclusion of the employment any unearned portion of the retainer is then returned by the attorneys to the Debtor or, if appropriate, to the Chapter 7 Trustee. See In re Pannebaker, 198 B.R. 453, 459 ("A pre-petition security retainer is a traditional valid and proper means for an attorney for a Chapter 11 debtor to secure some assurance of future payment").

The security retained constitutes a possessory security interest under the Uniform Commercial Code in the funds in the attorney's possession, and remain as collateral for Debtor's counsel to the extent fees are subsequently approved by the Court for payment. Pursuant to N.C.G.S. § 25-9-305, a security interest in money may be perfected by the secured party's taking possession of the collateral. Northen Blue has a security interest in the monies in the trust account just as a landlord has a security interest in a deposit. The law firm required that the retainer be paid in order to induce counsel to take on the representation. The Debtor applied to the Court to retain counsel and counsel fully disclosed the terms and conditions of the employment which was approved by the Court. No fees have been paid to counsel without authorization of the Court. The conversion of the case from a Chapter 11 to a Chapter 7 does not diminish the security interest Northen Blue has in the monies in the trust account. Therefore, in as much as the Court has approved fees and expenses greater than the amount of the monies presently in the trust account, the Court directs that the monies in the trust account be used to pay the fees and expenses of the firm and that the firm be allowed a general Chapter 11 cost of administration claim for the balance of the approved fees and expenses.

CONCLUSION

In accordance with the foregoing findings of fact and conclusions of law, the court will enter an order contemporaneously with the filing of this memorandum opinion authorizing the

payment to Northen Blue of all remaining monies held in their trust account.

This the 20 day of August, 2001.

CATHARINE R. CARRUTHERS

Catharine R. Carruthers
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA

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ORDER

This matter came on for hearing on the "Request for Hearing on Application for Final Compensation of Northern Blue, L.L.P. Heard Prior to the Closing of the Chapter 7 Case." Appearing before the court were John A. Northen, Counsel for the Debtor and the Applicant herein, Sara Conti, the Chapter 7 Trustee and Michael D. West, Bankruptcy Administrator. In accordance with the memorandum opinion filed contemporaneously herewith, the Request to apply monies in the Northen Blue Trust Account to the payment of approved fees and expenses is hereby granted.

It is therefore ORDERED, that the monies in the Northern Blue Trust Account be applied to the payment of approved fees and expenses.

This the 20 day of August, 2001

CATHARINE R. CARRUTHERS

Catharine R. Carruthers
United States Bankruptcy Judge