

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF IOWA

IN RE:)
) Chapter 7
ON-LINE SERVICES, LTD. LLC)
) Bankruptcy No. 03-04806
Debtor.)

**ORDER RE U.S. TRUSTEE'S MOTION FOR ORDER DIRECTING
EXAMINATION OF COMPENSATION PAID TO DEBTOR'S COUNSEL**

This matter came before the undersigned on August 26, 2004 pursuant to assignment. Attorney Thomas Fiegen appeared as counsel for Debtor. Janet Reasoner appeared for the U.S. Trustee. Wesley Huisinga appeared as the Chapter 7 Trustee. After hearing arguments of counsel, the Court took the matter under advisement. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A).

STATEMENT OF THE CASE

The U.S. Trustee seeks examination of compensation paid to Thomas Fiegen of Fiegen Law Firm as counsel for Debtor. The Motion alleges the Law Firm may have taken payment from Debtor's retainer without authorization. It also questions the source of a portion of the retainer funds.

FINDINGS OF FACT

On-Line Services, Ltd. LLC ("On-Line") was experiencing financial difficulties in September 2003. Members of On-Line contacted Feigen Law Firm, P.C. (the "Law Firm"). On December 8, 2003, the members voted to retain the Law Firm and authorized the bankruptcy filing. The Law Firm requested a \$9,000 retainer to be paid prior to filing. On-Line's majority member, Michael L. Glick ("Glick"), signed the engagement letter. The Law Firm received payments of \$1,000 on October 16, 2003 and \$4,000 on December 4, 2003 toward the retainer.

On-Line gave the Law Firm a check for the final payment of \$4,000 on December 18, 2003. This check was returned for insufficient funds. After learning of the insufficient funds, Glick deposited personal funds in the On-Line account and

tendered a replacement check from the On-Line account to the Law Firm on December 22, 2003.

On-Line filed its Chapter 7 petition on December 23, 2003. In the Statement of Compensation, On-Line disclosed a payment to the Law Firm of \$8,791. After the filing date, the Law Firm continued to perform legal services for On-Line and draw down on the retainer. The U.S. Trustee inquired into the sources and uses of the retainer by the Law Firm. The Law Firm replied that a portion of the retainer was paid by Glick. The U.S. Trustee wrote another letter of inquiry to the Law Firm, to which no reply has been given.

On June 24, 2004, the U.S. Trustee filed a motion requesting the Court examine the compensation paid to the Law Firm. At the hearing on this motion, Assistant U.S. Trustee claimed that, postpetition, the retainer was property of the estate and could not be drawn down without a court order. The Chapter 7 trustee in the case stated that he made a request for turnover of the funds from the Law Firm dated July 16, 2004.

Law Firm's Trust Account Activity

Invoice Date	Description	Amount	Retainer Account Balance	Total Payment to Law Firm
10/16/03	Payment from Debtor	\$ 1,000	\$ 1,000.00	0.00
12/4/03	Payment to Law Firm	\$ (30.00)	\$ 970.00	\$ 30.00
12/4/03	Payment from Debtor	\$ 4,000	\$ 4,970.00	\$ 30.00
12/16/03	Payment to Law Firm	\$(517.50)	\$ 4,452.50	\$ 547.50
12/18/03	Payment from Debtor	\$ 4,000	\$ 8,452.50	\$ 547.50
12/22/03	Notice of NSF	\$(4,000)	\$ 4,452.50	\$ 547.50

12/22/03	Payment from Debtor	\$ 4,000	\$ 8,452.50	\$ 547.50
12/23/03	Date of Petition		\$ 8,452.50	\$ 547.50
1/12/04	Payment to Law Firm	\$(4,051.61)	\$ 4,400.89	\$ 4,599.11
2/4/04	Payment to Law Firm	\$(725.14)	\$ 3,675.75	\$ 5,324.25
3/8/04	Payment to Law Firm	\$(1,013.82)	\$ 2,661.93	\$ 6,338.07
4/02/03 (Posted 12/23/03)	Payment to Law Firm	\$(209.00)	\$ 2,462.93	\$ 6,547.07
4/02/04	Payment to Law Firm	\$(37.50)	\$ 2,415.43	\$ 6,584.57
5/03/04	Payment to Law Firm	\$(403.44)	\$ 2,011.99	\$ 6,988.01
6/02/04	Payment to Law Firm	\$(92.53)	\$ 1,919.46	\$ 7,080.54
7/01/04	Payment to Law Firm	\$(108.76)	\$ 1,810.70	\$ 7,189.30

Law Firm's Prepetition Billing and Payment Activity

Period	Legal Fees and Costs	Payments	Outstanding Balance	Accrued Legal Fees and Costs
10/1/03 - 10/31/03	\$ 30.00	\$(30.00)	\$ 0	\$ 30.00
11/1/03 - 11/30/03	\$ 517.50	\$ 0	\$ 517.50	\$ 547.50
12/1/03 - 12/23/03	\$ 3129.27	\$(517.50)	\$ 3129.27	\$ 3676.77
12/24/03 - 12/31/03	\$ 922.34	\$ 0	\$ 4051.61	\$ 4599.11

1/01/04 - 1/31/04	\$ 725.14	\$ (4051.61)	\$ 725.14	\$ 5324.25
2/01/04 - 2/29/04	\$ 1013.82	\$ (725.14)	\$ 1013.82	\$ 6338.07
3/01/04 - 3/31/04	\$ 37.50	\$ (1013.82)	\$ 37.50	\$ 6375.57
4/01/04 - 4/30/04	\$ 403.44	\$ (37.50)	\$ 403.44	\$ 6779.01
5/01/04 - 5/31/04	\$ 90.00	\$ (403.44)	\$ 90.00	\$ 6869.01
6/01/04 - 6/30/04	\$ 108.76	\$ (90.00)	\$ 108.76	\$ 6977.77
7/1/04 - 7/31/04	\$ 0	\$ (108.76)	\$ 0	\$ 6977.77

CONCLUSIONS OF LAW

Retainer Funds as Property of the Estate

Under § 541(a)(1), at the commencement of the case, all legal and equitable interests of the debtor in property are property of the estate. The Eighth Circuit uses a three-part test to determine whether an interest is part of a bankruptcy estate. First, the item must constitute "property" under § 541(a)(1). Second, the court looks to state law to determine debtor's interest. Third, the court determines whether the debtor had the property interest at the time of filing the bankruptcy petition. In re Mahendra, 131 F.3d 750, 755 (8th Cir. 1997).

To illustrate how to perform the Mahendra test, the Eighth Circuit used a cash security retainer as an example of how property held by another would be property of the estate. Id. at 756. The cash security retainer works like a security agreement with a future advance clause. Id. In most states, the retainer remains property of the client until counsel applies the money to services rendered. Id. At the time of filing, the debtor's equitable interest in the unearned portion becomes property of the estate. Id.

Several bankruptcy courts hold that the unearned portion of a retainer in a chapter 7 case becomes property of the estate as of the filing date if the debtor retains an equitable interest in the account under applicable state law. See e.g., In re Brick Hearth Pizza, Inc., 302 b.r. 877, 882 (Bankr. D. Minn. 2003); Stewart v. Law Offices of Dennis Olsen, 93 B.R. 91 (N.D. Tex. 1988), aff'd, 878 F.2d 1432 (5th Cir. 1989); In re D.L.I.C., Inc. 120 B.R. 348 (Bankr. S.D.N.Y. 1990); In re Tri-County Water Ass'n, Inc., 91 B.R. 547, 551 (Bankr. D.S.D. 1988).

**Client's "Interest" in a Retainer
Account Under Iowa Law**

The Supreme Court of Iowa holds that clients have an interest in any retainer that is not deemed a general retainer. Iowa Supreme Court Bd. of Professional Ethics & Conduct v. Apland, 577 N.W.2d 50, 54 (Iowa 2001). A general retainer is money paid to an attorney in return for making legal services available as needed. Id. A special retainer is money paid to an attorney in advance of performing a specific service. Id. at 54. The Iowa Supreme Court presumes all retainers are special retainers where an advance fee has been given, unless there is evidence to the contrary. Iowa Supreme Court Bd. of Professional Ethics & Conduct v. Frerichs, 671 N.W.2d 470, 477 (Iowa 2003). Retainer funds are earned upon the performance of legal service but are considered paid when the funds move from the trust account to the lawyer's account. Id.

This court interpreted Iowa law and found: "The retainer, to the extent attorneys had not drawn upon it prior to filing, became property of the estate when the case was filed." In re Cargo, Inc., Bankr. No. X90-00200S, slip op. at 3 (Bankr. N.D. Iowa Jan. 24, 1992).

**Payment of Debtor's Attorney from
Property of the Estate**

Under current law, a debtor's attorney may not be paid by estate funds under § 330(a)(1). In 1994, Congress modified § 330(a)(1) by removing the phrase "... or to the debtor's attorney" from the list of professionals eligible for compensation from property of the estate. Under the prior version of § 330(a)(1), a debtor's counsel could be paid from the estate for services which provide benefit to the

bankruptcy estate. Cargo, Inc., slip op. at 4. Some courts continued to use the pre-1994 interpretation of the Code for the assessment of debtor's attorney's fees. See In re Kelchen, No. 95011471KC, slip op. at 3 (Bankr. N.D. Iowa March 29, 1996)(discussing cases).

The U.S. Supreme Court has ruled that a debtor's attorneys may not be paid using estate property, unless they are employed by the trustee and approved by the court. U.S. Trustee v. Lamie, 124 S. Ct. 1023, 1034 (2004). The timing of this case raises the issue of whether the Court should apply Lamie retrospectively. This case was filed on December 23, 2003. The Supreme Court issued its opinion in Lamie on January 26, 2004.

The Supreme Court holds that "In a free, dynamic society, creativity in both commercial and artistic endeavors is fostered by a rule of law that gives people confidence about the legal consequences of their actions." Landgraf v. USI Film Prods., 511 U.S. 244, 266 (1994). However, the Court also holds that, in the context of retrospective application, "When this Court applies a rule of federal law to the parties before it, that rule is the controlling interpretation of federal law and must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate our announcement of the rule." Harper v. Virginia Dept. of Taxation, 509 U.S. 86, 97 (1993).

Review and Adjustment of Prepetition Fees

The bankruptcy court may review and order the return of funds if it finds the prepetition fees unreasonable. Under § 329, the bankruptcy court may order return of payments made within one year prior to the petition date for fees related to legal services performed in connection with, or in contemplation of, the bankruptcy proceedings to the extent the prepetition payments exceed the reasonable value of the services provided. In determining reasonableness, the court has authority to disregard a fee agreement between a debtor and counsel. Mahendra, 131 F.3d at 757. The role of the bankruptcy court in determining reasonable value of attorney's services is to protect the interests of creditors of the estate by allowance of compensation only to extent actually and reasonably compensable for services provided. In re Swartout, 20 B.R. 102, 105 (Bankr. S.D. Ohio 1982).

"Reasonableness" in a § 329 context is a question of fact, individual to each set of circumstances. Id.

This court has established certain criteria for § 329 fee review. An attorney for a debtor is entitled to compensation for analyzing the debtor's financial condition, advising the debtor on whether to file for bankruptcy, preparing and filing the necessary petition, schedules and statements, and representing the debtor at the § 341 meeting of creditors. In re Burmester, No. 86-00710M, slip op. at 3-7. (Bankr. N.D. Iowa Dec. 8, 1987). This court will not allow fees for communicating with creditors unless it is shown that it benefits the estate. Cargo, Inc., slip op. at 4-5. Activities that do not benefit the estate include: review of pleadings, motions, and applications, communication with the firm's own client, and objections to trustee action unless the action benefits the estate. Also, the court will not allow a law firm to charge an unreasonable high rate. Id.

ANALYSIS

Retainer Account Becomes Estate Property at Filing

The funds held in trust by the Law Firm for On-Line satisfy the three-part test of Mahendra. The first and third prongs of the test are met. The retainer in the Law Firm's trust account is "property" under § 541(a)(1), and, at the time of filing, On-Line had an interest in that retainer. For the second prong, clients retain an interest in special retainers under Iowa law. The Law Firm provided Debtor with bankruptcy related legal services. The Law Firm's retainer is a special retainer, and therefore, On-Line had an interest in the funds held in the Law Firm's trust account.

At the date of filing, the trust account had a balance of \$8,452.50. Also, \$3,032.50 worth of legal services and \$114.20 of expenses were earned or accrued, but not invoiced or paid. Under § 541(a)(1), all property in which Debtor has a legal or equitable interest becomes property of the estate. Under Iowa law, the client retains an interest in the retainer until both the fees are earned and the money is removed from the account. Cargo, Inc., slip op. at 3. On-Line has an interest of \$8,452.50.

The Law Firm May Not Receive Funds from the Estate

In the past, debtors' attorneys were allowed to receive payments from the estate. Under the pre-1994 version of § 330(a)(1) and before the Lamie decision, debtors' attorneys could receive payment from the estate if the services were for the benefit of the estate. Under Lamie, § 330(a)(1) does not allow a debtor's counsel to be compensated from the estate without being hired by the trustee and approved by the court.

The pre-Lamie interpretation of § 330(a)(1) would yield the same result as the Lamie interpretation. As the Assistant U.S. Trustee stated in the hearing, the Law Firm should not receive any postpetition fees or expenses because this Court did not award the Law Firm compensation for work performed postpetition. In a pre-Lamie review, a court could award reasonable fees and expenses upon request of the debtor's attorney for work performed after the filing of the bankruptcy petition which benefits the bankruptcy estate. The Law Firm made no such request and no fees were awarded. Under Lamie, the Debtor's attorney may not be paid from property of the bankruptcy estate. In either case, the Law Firm receives no payment for postpetition work.

Reasonableness of the Law Firm's Prepetition Fees

The Law Firm billed \$3,579 for legal services and \$114.27 for costs that were performed or incurred prepetition. This court, in Burmester and Cargo, has set out the criteria for § 329 fee review. After review, the following prepetition charges are reasonable:

	Total Charge
Legal Fees	\$2,380.00
Expenses	\$114.27
Total Amount	\$2,494.27

Prepetition, the Law Firm incurred \$2,380.00 of reasonable legal fees and \$114.27 of reasonable expenses. The Law Firm was paid \$547.50 prepetition. This leaves a deficit of \$1,946.77 owed to the Law Firm for fees incurred prepetition.

CONCLUSIONS

At the time of filing, the On-Line's retainer of \$8,452.50 became property of the estate. The Law Firm is not entitled to payment from the estate under § 330(a). Of fees billed, the Law Firm is entitled to \$1,946.77 for reasonable prepetition services. This is not payable from the retainer which is property of the estate.

WHEREFORE, this Court enters the following orders:

1. The Court orders Debtor's counsel to turn over to the Trustee the amount of \$8,452.50.

2. Prepetition, the Law Firm incurred \$2,380.00 in reasonable legal fees and \$114.27 of reasonable expenses. These fees are approved. The Law Firm has already received \$547.50 toward this amount. It is entitled to the remainder of \$1,946.77. This is not payable from the bankruptcy estate.

3. Judgment to enter accordingly.

SO ORDERED this 28th day of October, 2004.



PAUL J. KILBURG
CHIEF BANKRUPTCY JUDGE