IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF WEST VIRGINIA

IN RE:	)	
	)	
GARY DOUGLAS SMITH	)	CASE NO. 92-20159
	)	
Debtor.	)	Chapter 7

MEMORANDUM OPINION

Mary Sue Smith objects to the final report of Arthur M. Standish, the Chapter 7 trustee (the "Trustee") for the converted bankruptcy estate of Gary Douglas Smith (the "Debtor"), on the grounds that the Trustee is not proposing to pay her about $26,666 that she claims is due based on the language of an attorney's retention agreement that Debtor executed with special counsel while his case was proceeding under Chapter 11. That retention agreement, which was never presented to the court for approval, provided that a portion of any proceeds recovered from the special purpose litigation commenced on behalf of the bankruptcy estate would be paid to Ms. Smith, to whom the Debtor owes a substantial amount of unpaid alimony. The Debtor responded to Ms. Smith's objection, and he requests that Ms. Smith not be paid anything from the bankruptcy estate.[1] The Trustee has not taken any position on the issue, and only requests guidance from the court as to how to proceed so that the case may be closed.

The court held a telephonic hearing on the Trustee's final report and proposed distribution

[1] The Trustee's final report reflects that general unsecured creditors will not receive any distribution from the bankruptcy estate. Thus, it appears that the Debtor lacks standing argue that Ms. Smith should not be paid any amount from his bankruptcy estate, and the court is uncertain as to why the Debtor filed a response to Ms. Smith's objection to the Trustee's final report. *See* 11 U.S.C. § 726(a) (providing the priority for distribution of estate property); *Stinnett v. LaPlante (In re Stinnett)*, 465 F.3d 309 (7th Cir. 2006) (" 'Only those persons affected pecuniarily by a bankruptcy order have standing to appeal that order. Debtors, particularly Chapter 7 debtors, rarely have such a pecuniary interest because no matter how the estate's assets are disbursed by the trustee, no assets will revert to the debtor.' ") (citation omitted).

in Wheeling, West Virginia on November 13, 2006,[2] at which time the court afforded the parties additional time to execute stipulated facts and briefs supporting their positions. All post-hearing submissions were completed by March 30, 2007, and the matter was taken under advisement. For the reasons stated herein, the court will sustain in part and overrule in part Ms. Smith's objection to the Trustee's final report.

I. BACKGROUND

The Debtor and Ms. Smith obtained a decree of divorce on October 10, 1991. Pursuant to the terms of the decree, the Debtor was to pay Ms. Smith $1,500 per month in alimony. As of January 2007, Ms. Smith claims that the Debtor is in arrears by $218,181.

On February 14, 1992, the Debtor filed a Chapter 11 bankruptcy petition. The Debtor complained that his bankruptcy petition was filed too late, and that if the petition had been filed earlier by his counsel, the estate would have included significant, additional assets. On November 12, 1993, the Debtor entered an agreement with attorney Michael Marlow to litigate this cause of action against his initial bankruptcy attorney. The legal services contract executed between the Debtor and Mr. Marlow provided that up to 50% of the net litigation proceeds (effectively 33 1/3 percent of the total recovery after payment of attorney's fees) would be paid to Ms. Smith to partially catch-up the Debtor's alimony arrearage debt.

Before that litigation was completed, the Debtor's case converted to Chapter 7 on January 7, 1997, and the Debtor received his discharge on June 10, 1997. On March 13, 2001, the court entered an agreed order settling the lawsuit against the Debtor's former attorney for $80,000, and the court authorized the payment of Mr. Marlow's $26,666 attorney's fee, plus expenses. The court, however, did not authorize any payment of the proceeds to Ms. Smith.

The Debtor did not list Ms. Smith on his Chapter 11 bankruptcy schedules, but Ms. Smith was aware of the Debtor's bankruptcy filing. Ms. Smith did not file a proof of claim in the Debtor's Chapter 7 case until March 22, 2007 – after the Trustee had prepared his final report. Pursuant to the Trustee's final report, after the payment of administrative expenses, the Trustee proposes to pay 10.36% on certain priority claims, with nothing paid to unsecured creditors. The Trustee does not

[2] The adjudication of this matter was assigned to the undersigned judge from the United States Bankruptcy Court for the Southern District of West Virginia.

propose to pay Ms. Smith any amount due to her under the retention agreement executed by the Debtors and Mr. Marlow.

II. DISCUSSION

Ms. Smith argues that Mr. Marlow's legal retention agreement should be enforced as written on the basis that: (1) the Debtor agreed to the legal services contract while his case was still in Chapter 11, (2) the Chapter 7 trustee was aware of the terms of the retention agreement and supported the mediated settlement reached by Mr. Marlow; (3) the alimony owed to her by the Debtor is excepted from his discharge pursuant to 11 U.S.C. § 523(a)(5), (4) the only complaining party in this case is the Debtor – no creditor of the estate has objected to Ms. Smith retaining a portion of the settlement proceeds, and (5) the legal services contract was either expressly or impliedly approved by the Trustee and/or the bankruptcy court when it approved the litigation settlement under Rule 9019; if no approval of the settlement was ever entered by the bankruptcy court, then Ms. Smith contends that she may still properly be heard in support or in opposition to the settlement. None of these arguments, however, allow Ms. Smith to earmark estate property for her sole benefit.

A. Untimely Filed Priority Claims in Chapter 7 Cases

As an initial matter, Ms. Smith filed a proof of claim in the Debtor's bankruptcy case on March 22, 2007, and the court must make a determination of whether or not the Trustee should amend his final report based on this untimely filing.

Ms. Smith was not listed by the Debtor as a creditor in his Chapter 11 schedules, and the last day noticed to file a proof of claim in the Chapter 7 case was May 8, 1997. No enlargement of time of this deadline is appropriate under Fed. R. Bankr. P. 3002(c) and 9006(b)(3) for allowing Ms. Smith's late filed claim nearly ten years after the scheduled bar date. Consequently, Ms. Smith's proof of claim is untimely filed.

However, to the extent that Ms. Smith's claim is a priority claim (Ms. Smith asserts in her filed proof of claim that she has a priority claim for $26,666), the fact that Ms. Smith's proof of claim is tardily filed will not bar a distribution on her claim by the Trustee. *E.g.*, 11 U.S.C. § 726(a)(1) (directing that the first monies distributed in a Chapter 7 case be applied towards the payment of priority claims listed under § 507); *Cooper v. IRS*, 167 F.3d 857 (4th Cir. 1999) (allowing

a tardily filed priority claim to be paid under § 726(a)(1) under the pre-1994 version of the statute, and stating that the 1994 amendments to § 726 made it even more plain that the court's result was correct); *In re Arnold*, No. 06-10671, 2007 Bankr. LEXIS 711 at * 5 (Bankr. E.D. Va. Feb. 26, 2007) ("In chapter 7, a priority claim is entitled to payment whether or not timely filed."); 6 *Collier on Bankruptcy* ¶ 726.02[3] (Alan N. Resnick & Henry J. Sommers eds. 15th ed. rev. 2006) ("It is now clear that if a priority claim is tardily filed before the chapter 7 trustee begins distribution, it is given the same treatment as if it were timely filed."). In this case, the Trustee has not begun distribution and Ms. Smith's late filed claim should be considered by the Trustee.[3] Accordingly, to the extent that Ms. Smith may be entitled to payment as a priority claimant against the Debtor's bankruptcy estate, Ms. Smith's objection to the Trustee's final report will be sustained.

Even if Ms. Smith's filed, priority claim garners no objection from the Trustee, however, there is not enough money in the Debtor's bankruptcy estate to pay priority claims in full. According to the Trustee's current report, after the payment of administrative expenses, only $18,250.95 is available for payment to other creditors. Consequently, the court must also consider the merits of Ms. Smith's arguments.

B. The Legal Services Agreement

Ms. Smith asserts that the attorney retention agreement executed by the Debtor and Mr. Marlow on November 13, 1993, before the conversion of the Debtor's Chapter 11 case to Chapter 7, should be enforced. That agreement provided:

> Client further desires that any and all sums of past due alimony payments be paid to Client's former wife out of any recovery in this matter in an amount not to exceed Fifty Percent (50%) of the Client's net recovery, if any, in this matter.

(Proof of Claim No. 69).

Importantly, the cause of action for which Mr. Marlow was retained to pursue was an asset of the Debtor's bankruptcy estate, and it concerned litigation against the Debtor's former attorney,

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[3] The court is not making any determination on whether or not Ms. Smith's claim is properly classified as a priority claim, the amount of that claim, or the relative classification among priority claims. Nothing in the court's ruling today would prevent the Trustee, or another party with proper standing, from objecting to Ms. Smith's filed proof of claim.

Mr. Braun. The basis for the litigation was that Mr. Braun allegedly neglected to file the Debtor's bankruptcy timely, which resulted in the loss of substantial assets from the estate. No allegation exists that Ms. Smith had an ownership interest in the cause of action against Mr. Braun. Accordingly, the legal services agreement constitutes an attempt to assign litigation proceeds – which are property of the bankruptcy estate – directly to Ms. Smith.

Regarding the legal services agreement, neither the Debtor, while the case was in Chapter 11, nor the Trustee, after conversion of the case to Chapter 7, sought bankruptcy court approval to retain Mr. Marlow as special counsel pursuant to § 327(e), which expressly requires court approval. 11 U.S.C. § 327(e) ("The trustee, with the court's approval, may employ, for a specified special purpose . . . an attorney . . ."). Without court approval, the retention agreement is invalid unless grounds exist to approve that retention nunc pro tunc. *E.g.*, *In re Jarvis*, 53 F.3d 416, 420 (1st Cir. 1995) (reasoning that a court's retroactive approval of an employment agreement is to be granted only in extraordinary circumstances, which are sufficient to excuse the failure to file a timely application); *F/S Airlease II v. Simon*, 844 F.2d 99, 105 (3rd Cir. 1989) (same); *In re Twinton Properties Partnership*, 27 B.R. 817, 819 (Bankr. M.D. Tenn. 1983) (formulating a nine-part test for determining whether a professional should be compensated under a nunc pro tunc order that approves the professional's employment).

While the record in this case reflects that the bankruptcy court awarded Mr. Marlow compensation, as the Trustee's counsel, when it entered the order approving the settlement of the litigation against Mr. Braun on March 13, 2001,[4] no indication exists that the court ever approved any express terms of a legal services agreement related to the lawsuit. Indeed, the agreed order granting the motion to compromise never mentioned any legal services contract. Although the motion to approve the litigation settlement mistakenly stated that Mr. Marlow was previously appointed as special counsel by the court, and it referenced a legal services agreement, the agreement was not attached to the motion and only term mentioned was Mr. Marlow's right to a 1/3

[4] This is a final order of the court and not subject to being revisited. Ms. Smith has not presented any grounds under Fed. R. Bankr. P. 9024, which makes Fed. R. Civ. P. 60(b) applicable to bankruptcy proceedings, for avoiding the court's order. For this reason, Ms. Smith's contention that she should now be allowed to voice her opposition to the agreed order settling the litigation against Mr. Braun has no merit.

contingency fee award. The court's review of the entire record in this case reveals that numerous applications to employ attorneys were filed by both the Debtor and the Trustee, but no application to employ Mr. Marlow was ever entered on the court's docket. No record exists in this case that sets forth the terms of that agreement before entry of the agreed order approving the settlement of the litigation. In sum, the court never approved of the legal services agreement, and without court approval, the legal services agreement is invalid. Accordingly, the fact that the Debtor consented, and that the Trustee may have consented to the terms of that agreement, is insufficient to meet the requirement of § 327(e) that the court approve the terms of the agreement.

Moreover, had the court been asked to approve of the terms of the legal services agreement, the court doubts that it would have approved earmarking a portion of the bankruptcy estate for a single party in contravention of the distribution priority rules set forth in the Bankruptcy Code. At the time that the Debtor entered the agreement with Mr. Marlow, proceeds from the property of the bankruptcy estate were to be distributed pursuant to a Chapter 11 plan that was capable for being confirmed by the court pursuant to 11 U.S.C. § 1129. After conversion of the case to Chapter 7, property of the estate must be distributed pursuant to the priorities set forth in § 726. Neither the Debtor nor the Trustee has the power to unilaterally alter this distribution scheme pursuant to an unauthorized legal services agreement. Consequently, Ms. Smith's objection to the Trustee's final report on the grounds that she is entitled to a direct claim to about $26,666 of the $80,000 in litigation proceeds realized by the bankruptcy estate in its litigation against Mr. Braun will be overruled.[5]

III. CONCLUSION

The court will sustain in part and overrule in part Ms. Smith's objection to the Trustee's final report. The Trustee should consider the priority proof of claim filed by Ms. Smith and make a determination as to whether or not to file an objection to that claim, or allow the claim as an

[5] Ms. Smith also argues that she should be entitled to the $26,666 on the basis that she has a claim against the Debtor that is excepted from his discharge. Claims excepted from discharge, however, are not entitled to special distribution priority under 11 U.S.C. § 726. To the extent that Ms. Smith has an allowed claim entitled to priority treatment under former 11 U.S.C. § 507(a)(7), however, she may be entitled to a distribution from the general funds of the bankruptcy estate.

untimely filed priority claim. The court will enter a separate order pursuant to Fed. R. Bankr. P. 9021.

Patrick M. Flatley 5-7-07

Patrick M. Flatley
United States Bankruptcy Judge